ABUSIVE TAX SHELTERS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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ABUSIVE TAX SHELTERS

TUESDAY, SEPTEMBER 28, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press releases announcing the hearing follow:]

[Press release No. 21 of Thursday, July 8, 1982]

HON. CHARLES B. RANGEL, DEMOCRAT, OF NEW YORK, CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, ANNOUNCES HEARING ON "ABUSIVE" TAX SHELTERS

Hon. Charles B. Rangel (D., N.Y.), Chairman of the Committee on Ways and Means, Subcommittee on Oversight, announced today that a hearing will be held to examine the range of issues surrounding the use of "abusive" tax shelters. The exact time and place of the hearing will be announced at a later date. This hearing will be the first of a series of Subcommittee hearings focusing on selected taxpayers compliance topics.

BACKGROUND AND ISSUES

The term "abusive" tax shelter is generally used to refer to investment schemes which claim tax benefits beyond those intended by law and those having little or no conomic reality. "Abusive" tax shelters may involve cattle, films, coal mining, oil nd gas, or foreign trusts; however, it is not the type of shelter which determines whether a shelter is inconsistent with a proper interpretation of the tax laws. ather, it is the underlying facts, characteristics and structure of the specific shelr which must be examined to determine its propriety. "Abusive" tax shelters are ften difficult to detect since both "abusive" and legitimate shelters rely upon the ame methods to reduce tax liability: (1) leverage which allows a taxpayer to deduct ot only the actual cash paid into an investment but also debts assumed as part of ie investment, (2) conversion of ordinary income into capital gain, and (3) deferral ' tax liability through accelerated depreciation or immediate expensing. However, abusive" shelters go far beyond the intent of the law and frequently utilize hemes such as backdating documents, overstating business expenses, claiming deuctions for debts not actually "at risk", grossly inflating the value of assets, assumg the existence of non-existent assets, and using foreign corporations or bank acunts to camouflage the nature of transactions and hide the identity of parties to ansactions.

The Subcommittee will examine the scope and extent to which "abusive" shelters ntinue to be promoted and utilized. Further, the Subcommittee will review curnt trends and the characteristics of "abusive" shelter arrangements for the purse of determining the sufficiency of existing statutory law and administrative les and related policies.

In the early 1970's, the Internal Revenue Service established a special Tax Shelter udit Program to identify "abusive" tax shelters schemes. This program has been eatly expanded and currently serves as the primary structures through which the S identifies and pursues the increasing large volume of "abusive" tax shelters

cases. The Justice Department prosecutes those cases involving criminally "abusive" shelters which, in most instances, have been referred to the Justice Department by the IRS.

The Subcommittee will examine the Internal Revenue Service and Justice Department's policies, procedures and commitment to identifying and curtailing the use of "abusive" tax shelters. In addition, the Subcommittee will review the impact and effectiveness of the IRS's Tax Shelter Program and related efforts, by both the IRS and Justice Department, to curb proliferation of such shelters.

In the Tax Reform Act of 1976 and the Revenue Act of 1978, the Congress enacted a significant number of major statutory provisions designed to eliminate the availability of excessive tax benefits through the use of shelter arrangements. Subsequently, the Economic Recovery Tax Act of 1981, increased the interest rate paid on the deficiencies, lowered the top rate of tax paid by individuals and established a new penalty for overvaluation of assets, all of which should affect the use of tax shelters. Currently the Committee on Ways and Means is considering a series of provisions, contained in H.R. 6300, directed towards curtailing future promotion and utilization of "abusive" tax shelters.

The Subcommittee will consider whether existing Code provisions adequately address the issues raised by "abusive" tax shelter arrangements. In addition, testimony will review the need for and impact of proposed legislation in this area.

Testimony at the hearing will be limited to invited witnesses including Administration witnesses representing the Internal Revenue Service, the Justice Department, and the Securities and Exchange Commission, and several witnesses from the private sector.

[Press release No. 24 of Tuesday, Sept. 14, 1982]

HON. CHARLES B. RANGEL, CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, ANNOUNCES SCHEDULING OF HEARING ON "ABUSIVE" TAX SHELTERS

The Honorable Charles B. Rangel (D., NY.), Chairman of the Committee on Ways and Means' Subcommittee on Oversight, announced today that the hearing on "abusive" tax shelters will take place on Tuesday, September 28, 1982, beginning at 10:00 a.m. in the Main Committee Hearing Room, 1100 Longworth House Office Building. This hearing was previously announced in Press Release #21, issued July 8, 1982, which described the purpose and scope of the hearing.

Testimony at the hearing will be limited to invited witnesses including Administration witnesses representing the Internal Revenue Service, the Justice Department, and the Securities and Exchange Commission, and several witnesses from the private sector. However, interested persons wishing to file a written statement for inclusion in the printed record of the hearing should submit five copies to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515, no later than the close of business Friday, October 15, 1982.

Chairman RANGEL. The Subcommittee on Oversight will commence its hearings this morning to discuss abusive tax shelters.

The growing use of illegitimate tax shelters continues to be a subject of much concern to members of the Committee on Ways and Means.

Recent press accounts relating to "multiple tax writeoff deals"—or arrangements where one pays $1 into a tax shelter partnership for the purpose of generating 4 dollars' worth of tax deductions—have generated inquiries from the public and congressional members for oversight hearings on the subject.

I think it is clear that this committee has been involved in a lot of legislation designed to correct some of the abuses that we have seen in the tax shelter area.

It is indeed unfortunate that there is such a thin line between what is abusive and what is legal that public officials in very high places have been unable to distinguish the difference. Because of this there is a question in my mind and in the minds of many of

the Members of Congress as to whether or not there is going to be generated an attitude in this country that you can do what you want to do as long as you don't get caught or whether there is going to be a sense that we are prepared in the Congress and in the administration to make certain that the tax laws are enforced fairly for both individuals and corporations.

We hope to be going into some of the tax shelter practices that are considered legal, those that are considered abusive, the problems that the IRS is having with the backlog of shelter cases, whether any additional legislation is needed, what is being done about those cases that have already been set aside for further investigation, what problems the IRS is having with the courts and, generally speaking, whether we have a handle on this situation.

We will start off with Commissioner Egger but before we do that I want to make certain that my colleagues have an opportunity to make a statement if they want.

[The prepared opening statement of Mr. Rangel follows:]

OPENING STATEMENT BY CHAIRMAN CHARLES B. RANGEL

The Oversight Subcommittee hearing this morning is being held to discuss "abusive" tax shelters.

The growing use of illegitimate tax shelters continues to be a subject of much concern to Members of the Committee on Ways and Means. Recent press accounts relating to "multiple tax write-off deals"—or arrangements where one pays $1 into a tax shelter partnership for the purpose of generating $4 worth of tax deductions—have generated inquiries from the public and Congressional Members for Oversight hearings on the subject.

In light of recent drastic cutbacks in the Nation's social, educational and health programs, I believe that it is imperative that the Congress and taxpayers nationwide examine and fully understand the use and characteristics of "abusive" tax shelter schemes. These illegitimate shelter schemes directly rob the people of taxes due the Federal Government and should not go unchecked. Reports indicate that billions of dollars are lost each year as a result of "abusive" shelter deals.

The main focus of this hearing will be on "abusive" tax shelters. While the term "abusive" is somewhat a term of art, such shelters are generally referred to as investment schemes which claim benefits beyond those provided for or intended by the tax laws and which have little or no economic reality. Some "abusive" shelters involve criminal conduct or border on criminal acts. However, most of the shelter returns we are going to discuss today are "abusive" in the sense that if the IRS audited the tax shelter return it would, without question, disallow the deductions or credits claimed.

One purpose of the hearing will be to discuss the characteristics of "abusive" tax shelters and explore why such schemes have been able to proliferate. The IRS, the Justice Department and the SEC have established practices for identifying and handling "abusive" tax shelter arrangements which we will examine. In addition, the Subcommittee will review the benefits of and problems likely to be encountered from implementation of the provisions contained in the recently passed tax bill designed to deter further growth of abusive shelters. I think we all agree that the "abusive" tax shelters need to be handled in a productive and controlled manner.

We will hear from representatives of the American Bar Association and practicing attorneys who have long been concerned with the use and availability of "abusive" shelter deals. Mr. Roscoe Egger, Commissioner of the Internal Revenue Service, is our first witness.

Chairman RANGEL. Mr. Moore.
Mr. MOORE. No.
Chairman RANGEL. Mr. Shannon.
Mr. SHANNON. No comment.
Chairman RANGEL. Mr. Duncan.
Mr. DUNCAN. No.
Chairman RANGEL. Mr. Egger.

STATEMENT OF ROSCOE L. EGGER, JR., COMMISSIONER OF INTERNAL REVENUE, ACCOMPANIED BY KENNETH GIDEON, CHIEF COUNSEL

Mr. EGGER. Thank you, Mr. Chairman.

I am very pleased to be here today to discuss the subject of abusive tax shelters.

Here with me is Ken Gideon, Chief Counsel for the Internal Revenue Service, as well as other Service officials here who are very familiar with this whole problem of abusive tax shelters.

I have thought quite a bit about the appropriateness of continuing to use the term "abusive tax shelters." Many of the schemes being marketed today are not really tax shelters at all, but outright fraud. As my testimony will point out, when the tax shelter business first started, the shelters that were marketed stretched the law in many cases, but generally did not break it. Congress, in reacting to those problems, closed loophole after loophole exploited by shelter promoters. Lacking the options permitted by earlier law, a growing number of unscrupulous promoters have turned to outrageous asset or service value overstatements, nonexistent or rigged transactions, and similar clearly fraudulent schemes.

I believe that, thanks to your efforts on the 1981 and 1982 Tax Acts [ERTA and TEFRA], the Service does now indeed have some effective tools to combat this problem. Later in my testimony, I will discuss some of the many specific penalties and powers that the Service now has. But right at the beginning, I wish to make it very clear to individuals who may be thinking of investing in tax shelters, and to those promoters who may be thinking of starting out, that the downside risks are now very different and quite substantial. In cases where essential tax evasion is involved, we intend to impose in vigorous fashion the new fines and penalties enacted by Congress and, when appropriate, prosecute under the criminal sanctions of the code those responsible.

DEFINITION OF AN "ABUSIVE" TAX SHELTER

It is difficult to define in a precise, academic manner an abusive tax shelter. Any definition would be unlikely to cover all of the possible permutations and contingencies which could be created by promoters of such shelters.

The Internal Revenue Code itself does not define an abusive tax shelter, although it should be noted that any tax shelter contemplated by the code is by definition nonabusive, whatever its form or substance. While section 320 of the Tax Equity and Fiscal Responsibility Act of 1982, in adding section 6700(a)(2)(A) to the code, does describe certain characteristics of an abusive shelter, it is not a definition per se.

The Internal Revenue Manual contains what we have found to be useful working definitions of abusive and nonabusive tax shelters. Those definitions make the following distinctions:

Nonabusive tax shelters involve transactions with legitimate economic reality, where the economic benefits outweigh the tax benefits. Such shelters seek to defer or minimize taxes.

Abusive tax shelters, on the other hand, involve transactions with little or no economic reality, inflated appraisals, unrealistic

allocations, et cetera, where the claimed tax benefits are totally disproportionate to the economic benefits. Such shelters typically seek to evade taxes.

Our manual's definition implies—correctly, I believe—that there is a broad spectrum of tax shelters.

At the obvious extremes, there are the clearly abusive and clearly nonabusive shelters. Between these extremes, there is a gray area where the basic nature of a tax shelter can only be determined by a factual analysis of its components. However, once all the facts are known, the determination of abusive versus nonabusive is relatively easy to make. But getting those facts is often the most complicated part of the process. This is particularly troublesome in the case of certain of these schemes which involve foreign jurisdictions.

Generally, abusive tax shelters utilize extreme, improper, and even illegal interpretations of the law or involve incomplete or misleading facts to attempt to secure for investors substantial tax benefits which are clearly disproportionate to the economic reality of the transactions. In a very real sense, abusive tax shelters are entered into with little or no expectation of a positive financial outcome, but rather, the sole expectation of evading taxes.

As I said earlier, Mr. Chairman, we believe that a large number of the abusive tax shelters being sold today are not really tax shelters in any traditional sense, but fraud euphemistically referred to as tax shelters. Such frauds are characterized by backdated documents, fictitious notes, false affidavits, inflated appraisals, rigged transactions, and forged trading records, as well as a number of other clearly illegal mechanisms. We are seeing more and more of these devices all the time, many of which involve foreign tax havens, substantially hindering our ability to obtain evidence relating to their true nature.

We recognize that legitimate investments in sound business activities should be encouraged; in fact, existing tax laws in many cases are structured for this very purpose. However, the viability of our tax administration system depends to a great extent on taxpayers' perceptions that the system is fair and equitable, and is administered in a fair but firm manner. When abusive, illegal, and fraudulent tax shelters are openly touted as proper investments, public confidence in the tax system declines rapidly, producing the likelihood of reduced revenues and voluntary compliance and all that that implies. We do not believe it is in the best interests of the Service, the administration of the tax system, or the Nation as a whole to allow this to happen.

A BRIEF HISTORY OF TAX SHELTERS

Tax shelters are not a new form of investment, nor were they created by any particular group for any particular purpose. The growth in the merchandising of tax shelters we have witnessed began as a reflection of the sheltering provisions of the code.

These provisions, however, were intended by Congress as investment incentives, not as mechanisms to intensify tax avoidance or deferral. They do not function as intended when carried to the extremes we have seen.

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The growth of the shelter industry intensified through the 1960's and into the early 1970's, at least partially in response to tax legislation of the period, as well as various economic considerations—inflation, stock market declines, et cetera—this rapid growth forced responses by both Congress and the Service. The Internal Revenue Service developed a number of administrative and operational arrangements, including the tax shelter program I will discuss later. Congress responded by enacting limits on the use of these devices, such as the at risk rules first introduced in the Tax Reform Act of 1976.

Overall, this period can be characterized as one of continual leapfrogging between the Service and the Congress on the one hand, and tax shelter promoters on the other. Each time the IRS or Congress developed a method of slowing or halting some objectionable shelter practice, promoters and/or investors would find some way around it—essentially jumping over the roadblocks. The important thing to remember here is that while at the beginning the promoters were only stretching the law, by the end of this period they were openly breaking it. This is the situation we find ourselves in today.

EXAMPLES OF ABUSIVE TAX SHELTERS

To illustrate what I mean, let me provide just a few examples of current tax shelter schemes we believe are abusive. There are many other examples we would be pleased to share with you at a later date. For obvious reasons, we have eliminated names and other identifying information from the following fact patterns.

One of the newest and most flagrant tax shelter schemes to appear in the last few years involves an overinflated asset value, as do most abusive tax shelters. However, this scheme is novel because:

One, the overvaluation of the asset occurs at the promoter level, rather than the investor level.

Two, the scheme not only defers the current year's tax liability, but also allows the investor to obtain a quick refund of prior years' taxes.

Three, the Government, because of the refund of prior years' taxes—actually pays the cash required to invest in the scheme. This results in the scheme being marketable to a much broader range of taxpayers.

The scheme operates in the following manner: An entity that purchases a master recording for $100 sells it to a production company for $2,500. The production company sells the master to a corporate promoter for $250,000—or 100 times their cost—the corporate promoter pays 1 percent cash—or $2,500, which was the original cost to the production company—executes a 12-year recourse note. This leverage factor of 99 to 1 is the most flagrant discovered to date. The note payments prior to the 12th year are from the proceeds of master recording sales. At the end of the 12th year, when the note is due and payable, we assume the only corporate assets that will be available for the production company to proceed against will be its own original master recording, which results in the note being essentially nonrecourse.

The corporate promoter leases the master for 7 years, on a non-exclusive lease, to investors who are individuals and partnerships for a $16,000 lease expense. The corporate promoter elects to pass through to the investor the investment tax credit [ITC], which is based on the $250,000 ostensibly paid by the promoter for the master.

The scheme generates deductions and ITC which presumably flow to the investors, eliminating their current tax liability and creating unused ITC to carry back to prior years.

The investors file form 1045—tentative carryback allowance—carrying back the unused ITC to the 3 prior years and eliminating the tax liability in those years. Under IRC 6411, that money is required by statute to be refunded within 90 days. The promoter will lend investors the cash, at 20 percent interest, to invest in the scheme. Upon receipt of the quick refund, the investor pays off the loan from the promoter.

This scheme was sold in 1979, 1980, and 1981 with the following estimated impact:

In 1979 promotion—over 700 investors with about $10 million ITC carried back;

In 1980 promotion—nearly 1,700 investors with over $17 million ITC carried back;

And in 1981 promotion—an estimated 2,800 investors with some $30 to $35 million ITC carried back.

The total impact of this scheme for 3 years is estimated to be about 5,200 investors, with some $57 million to $62 million ITC passed through to them.

As another example of a scheme typical of those we encounter, a promoter might arrange for an investor to purchase a lithographic plate at an inflated value, with the purchase price being highly leveraged by a promissory note. The parties agree beforehand that no real liability will attach to the signer of the note. The lithographic plates are then leased back to the artist for a rental amount that is contingent on the amount of proceeds derived by the artist from subsequent sales of prints from the plates The artist may have no intention to ever market prints from the plates and may, in fact, never physically receive the plates. The investor will claim investment tax credit and accelerated depreciation and, consequently, more than recover the cash outlay in first year tax savings alone. To add to the attractiveness—and abusiveness—of such a package, the documentation may be backdated to create the desired deductions in a year that is already otherwise closed for the investor.

Another ploy the Service has encountered over and over involves the overvaluation of works of art that may be donated to charitable organizations. A promoter may provide an appraisal of four or five times the amount paid by the investor for the art work, thus creating a 100 percent or greater return on investment for a taxpayer in a 50-percent tax bracket when the object is subsequently donated. Once again, deductions may be created for any desired tax year by means of backdated documentation supporting fictitious dates of purchase and donation.

SCOPE OF THE PROBLEM

In 1973, the Service began a tax shelter program focusing on four areas: oil and gas, real estate, movies, and farming. Initially, about 400 shelter cases were under examination. In the late 1970's, as the popularity of tax shelters increased, their marketing became more aggressive, and the number of abusive schemes grew. The schemes offered became more and more egregious.

By the beginning of 1980, when the Service initiated its current program to combat abusive shelters, there were over 174,000 shelter returns under examination--involving 19 different general categories or types—and 1,900 cases in litigation. Today, there are almost 300,000 shelter returns under examination by the IRS. Over 16,000 shelter cases are currently pending before the Tax Court, which is equal to roughly 30 percent of the total docket.

Further, our Criminal Investigation Division has already recommended prosecution of approximately 81 promoters/brokers of tax shelter schemes for this fiscal year. There are approximately 13,388 investors involved in these 81 schemes, with an estimated tax recovery of approximately $2.6 billion.

I might also mention that our current inventory of criminal investigation cases is over 200.

IRS ACTIONS

Our efforts to combat abusive tax shelters have centered on IRS' tax shelter program, which uses the combined skills of representatives of our Examination, Appeals, Criminal Investigation and Chief Counsel functions in both the field and the National Office.

Many of our resources are being concentrated on shelter cases involving pre-1981 tax years. Roughly half of the almost 300,000 pending shelter cases involve these old years. Only recently, as a result of ERTA and TEFRA legislation, has the Service been armed with the specific tools to deal with both the investors and the shelter promoters. The lack of specific and appropriate penalties applicable to shelters involved in those old years has severely handicapped our ability to deal with the shelter problem. Substantive changes in our tax laws in the past few years also minimize the precedential value of litigating the cases involving old years. The proliferation of new schemes demands that we concentrate our resources on the post-1980 shelter inventory.

In light of the size of our old inventory, our resource constraints, recent tax shelter legislation, and the need to concentrate on the current shelter abuses, we believe an out-of-pocket expenses approach is an appropriate basis for disposing of these old cases. Accordingly, I approved Policy Statement P-4-64 on this topic last month, which will allow Examination to consider such offers in cases arising from pre-1981 tax years. The out-of-pocket approach allows a deduction to the extent of the cash investment in the initial year and disregards nonrecourse loans. Under this approach, taxpayers will receive no artificial tax benefits from their participation in abusive shelters; rather, they will receive only a dollar deduction for each actual dollar invested.

Counsel is committed to pursuing an aggressive tax shelter litigation program designed to generate additional favorable precedents,

as well as to encourage early settlements. This tax shelter litigation program involves the selection of certain groups of tax shelter cases for expeditious processing through the litigation system. For example, if a particular promoter or representative declines to accept an out-of-pocket settlement, we would then consider targeting that group of investors for early litigation.

From the investor's perspective, there is now an overvaluation penalty ranging from 10 to 30 percent of the deficiency if the tax benefit claimed results from an overvaluation. The existing 5 percent negligence penalty has been augmented by an additional penalty of 50 percent of the interest due on the portion of the underpayment due to negligence. The interest rates on tax deficiencies will be regularly adjusted to market rates; moreover, interest will now be compounded daily. Finally, and perhaps most significantly, a penalty for substantial underpayments may be imposed for investors in abusive shelter transactions. The Service also will consider criminal prosecution when the investor himself knowingly participates in a fraudulent scheme.

From the promoter's perspective, you now have provided the Service with truly effective civil sanctions that deal specifically with the marketing of tax shelters. In the past, our enforcement activities against promoters have been primarily in the criminal prosecution area. Now, there are provisions to permit the Service to seek injunctions to stop the sale of abusive shelters and to impose civil penalties on those promoting and assisting in the promoting of such shelters. By aggressive use of these new tools, we hope to halt clearly abusive shelters before they can create enforcement problems of the size I described earlier.

The new shelter promoter penalty and injunction provisions, coupled with continued criminal prosecutions, should permit the Service to directly attack the sources of the current shelter problem. Indeed, we hope to develop techniques which will not merely deter by punishment such behavior after it has occurred, but essentially stop it in midstream. To date, we have obtained indictments/information on 88 promoters/brokers, 45 of whom already have been convicted on criminal charges. Included in that total for fiscal year 1982 alone are 38 indictments/information and 30 convictions of promoters/brokers selling these fraudulent tax shelters.

CONCLUSION

In sum, the IRS is very concerned about abusive tax shelters and their effect on revenues and voluntary compliance. We will do our best to uncover these penalties. As we do, investors will be subject to fines and penalties and promoters will be dealt with severely. The provisions of ERTA and TEFRA legislation that I noted earlier have provided us with the statutory tools to accomplish these ends. Given the resources already requested for the Service for fiscal year 1983, we will be in a position to make substantial strides in this area.

If I could summarize my message to the American taxpayer on abusive tax shelters in one sentence, it would be this: "Caution—Participating in abusive tax shelters can be hazardous to your wealth."

Mr. Chairman, my associates and I will be pleased to try and answer any questions you or the members may have.

[An attachment to the statement follows:]

NEWS RELEASE FROM THE INTERNAL REVENUE SERVICE

WASHINGTON.—The Internal Revenue Service today cautioned taxpayers about end-of-the-year investments marketed by unscrupulous promoters that lack sound business purposes and promise large tax savings.

Generally, the IRS said, abusive tax shelters involve artificial transactions that lack economic reality, inflated appraisals, unrealistic allocations, "wholesale" buying to reap charitable contribution deductions at retail, and package deals designed at the start to generate losses far in excess of present or future investment.

While the term "abusive" has been applied to tax shelter plans that are contrary to law, many shelters are characterized by outright fraud containing both shallow and complex aspects designed to carry out willful evasion. Earlier the plans were marketed to stretch the law and recently many are clear attempts to evade. Often the frauds involve backdated documents, fictitious notes, false affidavits and forged trading records.

Abusive shelters often involve nonrecourse loans for which the taxpayer is not liable for payment and that inflate losses or other deductions. Frequently, the financing is packaged to give the appearance of a personal obligation when it is in fact nonrecourse. Such financing has been used to inflate deductions and credits to make them larger than the cash investment. However, the law generally provides that the amount on which an investment tax credit is computed and the amount of deductions for losses is limited to amounts actually risked in the venture.

Some abusive tax shelters have been effectively dealt with by the IRS or Congress and have virtually disappeared from the market. For example, the commodity straddle, formerly a popular shelter, has been curtailed effectively by the Economic Recovery Tax Act of 1981. It has been replaced, however, by other shelter schemes ranging from growing jojoba beans to leasing and subleasing energy management devices.

According to the IRS abusive tax shelters are concocted daily by promoters so an all-inclusive list of factors in determining what is abusive is not possible, but potential investors would be wise to consider the following questions which might provide a clue to the abusive nature of the plan:

1. Do the tax benefits far outweigh the economic benefits?
2. Is this a transaction you would consider seriously apart from the tax benefits if you hoped to make a profit?
3. Do the shelter's assets really exist? Are they insured for less than their purchase price?
4. Is there a non-tax justification for the way profits and losses are allocated to partners?
5. Do the facts and supporting documents make economic sense? In that connection, are there sales and resales of the tax shelter property at ever increasing prices?
6. Does the investment plan involve a gimmick, device, or sham to hide the economic reality of the transaction?
7. Does the promoter offer to back-date documents after the close of the year and are you instructed to back-date checks covering your investment?
8. Is your debt real or are you assured by the promoter that you will never have to pay it?

In recent years the government has obtained indictments/informations on 88 promoters of abusive tax shelters, 45 of whom already have been convicted. So far this fiscal year, 30 convictions have been obtained and criminal prosecutions recommended against 81 promoters or brokers. More than 13,000 investors are involved in the 81 schemes with an estimated tax recovery of $2.6 billion.

Currently the IRS is examining more than 281,000 tax returns that appear to involve abusive tax shelter issues. Through the first eleven months of fiscal 1982 the completed examination of 61,772 returns in the abusive tax shelters program resulted in recommended tax deficiencies of $824.3 million.

IRS advises potential investors to consider all the facts and circumstances involved, seek competent counsel and in some cases even request an advance ruling from the IRS before entering into the transaction.

Chairman RANGEL. That statement is so out of character with your normal serious posture.

Tell me, how much money are we losing as a result of these tax shelters?

Is it safe to say that this panel or this committee can refer to abusive tax shelters as opposed to criminal tax shelters?

Mr. EGGER. Well, as I said in the first part of my testimony, it is sometimes hard to draw that line because anything that constitutes a fraud——

Chairman RANGEL. There just seems to be so few cases that end up in the Justice Department that to the average taxpayer, the rule is whatever you can get away with, even though it is abusive, you do it.

Now, how much money are we losing annually, would you say, as a result of abusive tax shelters?

Mr. EGGER. Mr. Chairman, I am not sure I can even give you any kind of an estimate on it because of the fact that we don't really know how much of it or the extent of it that is out there.

Let me turn to some of my colleagues to see if they have collectively, any kind of an estimate.

Well, just based on the number of cases that we have under examination at the moment using the approximate $12,000 per return, it is approximately $3 to $4 billion that we know about. And I have seen some shelter schemes that if, in fact, they were successful, could involve as much as $4 billion all by itself over about a 5-year period.

Chairman RANGEL. Well, you are optimistic that now that you have the legislative and administrative tools to work with you will be able to get some control over these abuses?

Mr. EGGER. We are very confident of that, Mr. Chairman.

The 1982 legislation has put in our hands many of the tools that we just simply lacked heretofore to deal primarily with the promoters themselves.

We are a little bit apprehensive about one aspect of the shelter business which we just haven't been able to deal with and that is the problem of the combined use of the accrual method of accounting and certain techniques for computing such things as interest deductions.

We have seen some of the shelters where an accelerated interest calculation was combined with the accrual method and where, as we have seen in many of these schemes, the so-called recourse debt obligations are stretched out over 10, 12, 15, and sometimes a 20-year period with nothing due at the beginning and no payments due during the interim except on a contingent basis such as the sale of prints or the sale of recordings, or whatever, that may never take place and where the interest is accrued under an accelerated method such as the rule of 78's.

Those produce, theoretically, extremely high deductions in the early part of the period with, on the face of it at least, very little likelihood that any of that money will ever be paid.

When you combine an accrual basis corporate promoter, for example, with a cash basis investor, we get some pretty weird results. We haven't gotten deeply enough into this to know whether additional legislation is going to be required or not but you can rest assured that as soon as we have some kind of an answer that we will be back up here talking with you about it.

Chairman RANGEL. Well, I think you said that we have some 300,000 shelter returns under examination.

Mr. EGGER. Yes.

Chairman RANGEL. You don't have any resource problem in dealing with that?

Mr. EGGER. Our principal problem in dealing with the 300,000 cases has been in the Appeals and Tax Court areas and we believe that given the settlement posture that we have assumed now on these pre-1981 cases that we are going to be able to dispose of a large number of that inventory and the others will await trial in the Tax Court.

Now, given the huge inventory of cases in the Tax Court for the moment, many of these things may have to wait quite a while to go to trial, but by the same token, the taxpayers involved in these abusive cases under the new law are going to be running on a very time sensitive basis and I believe that many of them will think a long time before they stand off and wait for 2 or 3 or 5 years to have the case decided against them with that kind of an interest time clock running.

Chairman RANGEL. Well, I can understand the problems with litigation but I understood that a special problem for the IRS involves the geographic dispersion of investors and promoters and the administrative complexities that result from this.

And as you mentioned, the manipulation of the Tax Code is a problem, not just forged documents and those things that are obviously illegal. Can't you construct some type of a form so that those people who seek to shelter their income would have to put certain documented information on that form so that your staff doesn't have to investigate each and every shelter?

Mr. EGGER. We are doing two things. No. 1 is we are already underway in implementing the partnership audit provisions which went into the 1982 act and which will be a tremendous help to us in dealing with massive numbers of investors who are geographically dispersed in these large schemes.

So I think given that and the strides that we are making in the area of being able to deal with geographic dispersion problems through our computerized combined case control system which is relatively new, thus permitting us to do away with massive amounts of paperwork at the examining agent level, all of these things are going to give us a great deal more ability to deal with these problems than we have had in the past.

Chairman RANGEL. Well, I know that one of your major objectives is to have the American taxpayer believe that there is integrity in the system and to do whatever you can to deter other people from abusing the system.

However, it is difficult for us, the Congress, and I guess the general public, to know exactly what you are doing and whether it is a deterrent.

Is there a public relations arm of the Service that could give warnings to those people that would like to manipulate the system illegally that shelters could be harmful to your wealth?

Do you have anything out there that would allow the lawyers and accountants to know that your office means business?

Mr. EGGER. We do this in our associations and relationships with the various professional groups. We meet periodically both in the field and at the national level with representatives from the accounting and legal professions as well as with return preparers and with other professional groups constantly stressing this kind of thing.

Only recently we met with the executive committee of AICPA tax division and this particular problem took up a great deal of the agenda.

Chairman RANGEL. Well, how does that help, Commissioner, unless you can tell them how many people went to jail? To me that is one of the deterrents. You go to the professional group and you list the members of the profession that went to jail. It is my understanding that only 36 tax shelter cases have been successfully prosecuted by the Justice Department in the last 3 years.

So, it would seem to me that with that type of a batting average, other taxpayers could take substantial gambles notwithstanding the eloquence of your speeches at these professional groups.

The question is, What are you able to do to show people that they can go to jail for violating the law?

I guess it has been assumed that you just didn't have enough resources. The court lag and a variety of other things enable promoters of these shelters to put some disclaimer in the promotional materials and tell the investor you are taking a gamble but 9 chances out of 10 you won't get caught.

Now we are trying to catch up. The IRS has new tools and we are trying to preserve our voluntary system. In other words, everyone that breaks the law will not go to jail but there should be a good chance that you would. I don't think there has been a good chance in the past and I have to admit that with the exception of your optimism I don't see it occurring in the future.

Mr. EGGER. Well, let me do two things.

First of all, I'd like to bring you up to date with the difference between what has been going on in the past and what is going on right now.

For example, in this current year we have already completed investigation in 162 cases which is a multiple of the number of cases that were investigated for criminal prosecution in a period of several years. Our current inventory is 215 cases.

We are getting from the Justice Department a considerably different kind of participation. For example, we have had this year a number of instances where Justice has been willing to assign attorneys from Washington to go into the field and work with the U.S. attorneys, or even take over grand jury investigations and so on in order to move those things along a little bit faster.

Our experience heretofore has been just terribly, terribly slow, sometimes as much as 2 or 2½ years from the time an investigation is opened before the indictment takes place.

We are doing everything we can to cut that time period down.

I'd like Ken Gideon to perhaps elaborate on some of that because he works more closely with Justice in that respect than I do.

Mr. GIDEON. We have attempted to engage in a lot closer coordination of our activities during the past year. We have been meeting on a regular basis to try to develop techniques that would get

us to the criminal prosecution phase a little faster. But I also think that it is important in this area for the committee to recognize the value of the civil sanctions that were provided in this last tax act in dealing with this particular problem.

There simply are not enough courts and other resources to put all abusive shelters through the criminal process, nor do I suspect that the committee would want us to do that.

On the other hand, by giving us effective civil sanctions to deal with this problem, I think that we can create a notion that there are real downside risks and that when we detect one of these schemes we have the tools to deal with it and to make it something other than just paying a little bit of interest if we catch you.

Chairman RANGEL. Well, I guess I have to be satisfied that since you are not asking for any legislative remedies, you have a sufficient number of tools. However, there has been a lot of publicity about people who invest in abusive shelters but do not get caught by the IRS. This makes other people think the system is unfair, and all we do is say that we wish it had not happened.

Let me ask, with all of the gray areas that we have with abusive tax shelters and acceptable tax shelters, what category did the Yale-Quay energy partnership fall into?

Mr. EGGER. I am sorry.

Chairman RANGEL. That partnership that Attorney General Smith invested in, what category would that type of investment plan have fallen into under the categories established by the Service?

Mr. EGGER. The only thing I personally know about is the news accounts and to the extent that it does involve an advanced royalty payment, we do have a published position on that taking the contrary position. We published in 1980 a revenue ruling dealing with that particular feature.

Chairman RANGEL. Well, they had a lot of things in that shelter. There was a 4-to-1 writeoff. There was a loan which you did not have to pay interest on or little or no interest. Just taking that general category, under what label would those types of arrangements fall? We are sending a message now to promoters and I would just like to state for the record that seeing all of the facts that were involved in that case, what message would we send out as it relates to the Yale-Quay energy partnership?

Would it be abusive? Would it be a regular shelter? Would it be a gray area? Is that established tax practice? Was it at risk? Was the loan legitimate? Have you looked at the matter at all since the articles in the Washington Post?

Mr. EGGER. I have not personally made any investigation of that. I'm satisfied that on the face of what you have stated and newspaper accounts, we would characterize it as an abusive shelter.

Chairman RANGEL. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Commissioner, I guess from listening to your testimony, reading it, and your answering of the questions of our distinguished chairman, that this matter really resolves itself down to an enforcement matter, rather than additional legislation; is that correct?

Mr. EGGER. With the exception of the area that I mentioned dealing with the accounting methods and so on, and the ability of the promoters to manipulate those things, yes, indeed. It does involve basically two things: It involves improved techniques for identification of returns and then the adjustment of those returns; that is to say, dealing with those returns by our field enforcement individuals.

Mr. MOORE. You mentioned a matter of accounting. Specifically, should we address that legislatively?

Mr. EGGER. Well, as I said earlier, we really don't know yet whether any legislative change is needed.

The technique, of course, is aimed at attempting to get around the at-risk rules in the code and so what we are trying to find out now is whether any legislation is needed. We don't know the answer to that yet.

Mr. MOORE. I assume that when you finish your study you will let this subcommittee know?

Mr. EGGER. Certainly, yes indeed.

Mr. MOORE. Would you recount just briefly what was done in last year's and this year's tax bills that gives you assistance in trying to bring this matter under control?

Mr. EGGER. Yes. Several things that I have made reference to here in the direct testimony have to do with the penalties, in the 1981 act, for example, was the penalty for overvaluation. The penalty goes from 10 to 30 percent of the deficiency, depending upon the extent of overvaluation. In addition, the 1981 act added on to the 5-percent negligence penalty, a penalty of 50 percent of the interest on the deficiency and then, finally, it increased the interest we charge from 90 percent of the prime rate to 100 percent of the prime rate.

Then in the 1982 act we had an additional series of penalties, adding the time-sensitive 50 percent of the interest on the deficiency portion of the negligence penalty to the fraud penalty, increasing the fraud penalties both at the corporate and individual level.

The increase, or I should say the establishment of a new penalty sometimes called the no-fault penalty applying where the deficiency is more than 10 percent or $1 threshold amount, regardless of whether any negligence is established or not. Now there are safeguards in that but, nonetheless, it was aimed at attempting to discourage, by a greater downside risk, people going into these shelters with the hope of playing the audit roulette game.

The summons enforcement provisions are going to be a tremendous help to us, and at the moment——

Mr. GIDEON. I was going to say there are many provisions, the improved partnership audit provisions should make our enforcement resources tremendously more effective. We think that the promoter injunction statute will allow us, as the Commissioner mentioned, to attack these transactions in midstream instead of having to wait until the audit process and the damage is done to try to pick up the pieces.

Mr. EGGER. Also, the promoter penalty, that is the penalty that applies to people who are participating in the promotion of these improper schemes, and that applies not only to the individual who

goes out and sells a scheme but it could also apply to accountants, and lawyers, and anybody else who is in the pipeline.

Mr. MOORE. Would it be fair to assume—to pick up on the chairman's concern, I share his concern about having the public aware of what can happen to them if they break the law. I think it is a concern that goes to all criminal statutes, period, a fact that we want to be darn sure the public knows. Hopefully they will find out about these people being penalized or caught when they break the law. Can we assume in this case that the kind of people who participate in these abusive tax shelters are fairly sophisticated people who have accountants and have attorneys? And can't we assume that the accountants and attorneys are warning them, as you indicated a moment ago, that the law has changed and that there is a good chance that they are going to pay a substantial penalty if, in fact, the scheme falls through?

Mr. EGGER. In my speeches and other discussions with the professional groups, I have continued over several months to emphasize the obligation, which the professions carry right along with those of us in Government, to see to it that that message is carried loud and clear, and the message is not to participate in promoting the schemes themselves.

I think that there is a limit beyond which one must use caution. I'm most reluctant to create an image of the Internal Revenue Service as some sort of a Gestapo-type police force as some people have referred to us already, and so I want to be careful that everyone understands that we are going to vigorously apply these sanctions, civil sanctions, and criminal sanctions in appropriate cases but that we are also going to make every effort to apply as much judgment as we can to see to it that they are not misapplied.

Mr. MOORE. I asked a question and you nodded your head and then gave a more detailed answer. Would you agree that an awful lot of these people are learning about these penalties through their CPA's and attorneys?

Mr. EGGER. I certainly expect so and, moreover, I have to say this, Mr. Moore: That I believe that a great many of the so-called investors in here are well informed as to what they are doing. I don't believe that most of these people go into these things blindly. I just don't believe it. I think that most of them understand what they are doing.

Mr. MOORE. Let me ask you another question.

Do you believe that lowering the maximum tax rate on investment income from 70 percent down to 50 as we did in last year's tax bill will take away the attractiveness for some of these investors going into these schemes?

Mr. EGGER. No question about it. I have no way of measuring that but I can, based on what I've already heard from people in the professions as well as business people in general, there is much less incentive for people to invest.

In the high State income areas, that is to say where State income taxes are relatively high, by the time you add the State tax to the 70-percent maximum tax that we had heretofore, it made quite a significant bite and, therefore, individuals reasoned that with only 12 or 14 cents left out of the dollar you might as well try some-

thing. So I think that, without any question, that drop in the maximum interest rate would be helpful.

Mr. MOORE. So, in effect, we have in last year's and in this year's tax bill decreased the incentive and increased the penalties toward these kind of shelters?

Mr. EGGER. Yes, sir, exactly.

Mr. MOORE. Mr. Commissioner, let me encourage you to do everything you can to push this very hard.

To follow up on a point made by our chairman, I think most Americans would grumble and say that we don't have enough of your employees auditing these kinds of things while too many of them are auditing the average taxpayer. I don't know if that is right or not, but I would hope that you would give this area all of the audit personnel necessary to be sure you are finding all of these things and then turning them over to your legal arm for challenge and taking to court, if that is required.

We do hear of cases and complaints about "why are they picking on me" when all these abusive tax shelters out there are going unchallenged. And I'd say to my chairman—I compliment him for having this hearing—I think the fact that we are having the hearing and we are making known to the public that there are increased penalties and increased enforcement efforts underway is most helpful. This should help reinforce what they should be hearing from their tax advisers, that, indeed, shelters can be dangerous to their wealth; to quote our Commissioner.

Mr. EGGER. We certainly intend not only to step up the number of examinations but, perhaps more importantly, we are doing everything we can to refine our selection system so that the returns that are selected for audit are those that ought to be and attempting to eliminate or certainly reduce the number of returns that come up for examination that do not really require adjustment.

Mr. MOORE. Thank you, Mr. Commissioner.

Chairman RANGEL. Mr. Shannon.

Mr. SHANNON. Thank you, Mr. Chairman.

Thank you, Mr. Commissioner, for your testimony.

I notice we all want to work together to eliminate as many abusive tax shelters as possible as quickly as possible. One of the big problems, of course, is that these are so complex nobody really understands them outside of your department and a few staff people up here on the Hill, and the few people who put these things together. There are not many people who understand the complexities of these things and it's difficult to catch the public's attention on these things.

Occasionally one comes along involving a prominent person, as with the Attorney General, and we hear a lot of grumbling and there is a lot of attention focused on it. So I'd like to ask you a few questions about how the Service handled the Yale-Quay energy partnership.

You testified to us about the tax shelter program. Was that energy partnership reviewed by the tax shelter program?

Mr. EGGER. Mr. Shannon, I cannot by law testify as to what we have done in any specific case. Section 6103 precludes my discussion of that in this kind of a hearing.

Mr. SHANNON. I understand that you can't talk about individual returns but can't you tell us something about whether the Service has taken any action against any of the promoters of this particular partnership?

Mr. EGGER. That also falls under section 6103.

Mr. SHANNON. Well, you have already characterized this partnership as abusive. Do you want to retract that?

Mr. EGGER. I can and did characterize what I was told about and the newspaper accounts, but I do not and cannot discuss any specific individual case.

Mr. SHANNON. What is it about this tax shelter which is abusive in your own opinion?

Mr. EGGER. The question that was put to me by the chairman was based upon a statement concerning long-term payouts and 4-to-1 return and things of that nature, and I said on the face of that I would characterize that as abusive.

As I know it, we were not talking about any specific taxpayers.

Mr. SHANNON. Any tax shelter with a 4-to-1 writeoff is abusive in your opinion?

Mr. EGGER. That is a characteristic, I would say. All by itself, certainly no one would characterize that alone as abusive. I think the combination of things was what I was addressing.

Mr. SHANNON. You have a policy, as I understand it, in the Service not to issue rulings where writeoffs are greater than 1 to 1. Is that correct?

Mr. EGGER. I know of no such policy.

Mr. GIDEON. I think, Mr. Shannon, a distinction needs to be drawn here between those areas covered by the at-risk rules that Congress adopted in 1976, and those areas not covered. The notable exception is real estate and as a result of real estate transactions where by law nonrecourse financing is permitted to add the writeoffs greater than 1 to 1 can and frequently do occur.

Mr. SHANNON. So you issued rulings in those cases?

Mr. EGGER. We have in this instance. I don't recall any specific ruling, but in an appropriate case we would rule on that subject.

Mr. SHANNON. What I am driving at is, are there not some standards that we should try to apply here so that investors can determine whether something they are entering into is abusive or not?

Are there not some rules of thumb that you use to try to determine whether or not a tax shelter is abusive?

Mr. EGGER. We have a program whereby specific shelter schemes are submitted by our field organization, by members of the professions and others sent to us in the national office. In the national office here, we have a group of people who then analyze those and then take the general fact pattern amd develop rulings for publication.

Our intent here is to identify a particular fact pattern as being abusive and stating our position so as to inform the would-be investors as to the likelihood of difficulty if they go into it.

So, it is in that fashion that we intend to attempt to head off or at least to prenotify, if you will, potential investors in the various schemes.

Mr. SHANNON. I want to ask you again, have you ever issued a favorable ruling with more than a 1-to-1 writeoff?

Mr. EGGER. I'm not sure I can answer that. If someone here can, fine, but otherwise, we will be happy to give it to you for the record.

Mr. Portney, who heads up our whole ruling effort, says that we just don't get requests for private rulings in the tax shelter area. By and large, people don't come in and ask questions that they don't think they will like the answers to.

Mr. SHANNON. So, to your knowledge, you never have issued a favorable ruling with a greater than 1-to-1 writeoff, is that correct?

Mr. EGGER. That is correct. We have not, but we will be happy to supply a final answer for the record.

[The information follows:]

The Service has published no favorable tax shelter revenue rulings. Further, our research indicates that no favorable private letter rulings have been issued concerning tax shelters.

In the private ruling area, determinations made with respect to certain issues that do not involve tax shelters per se could nevertheless have tax shelter implications. A good example of this—because so many shelter transactions are organized as limited partnerships—is the question of whether an organization that is to be formed and operated as a limited partnership will be treated as a partnership for federal income tax purposes. A favorable ruling on this question could inappropriately be used in promotional materials as an indication of Service concurrence with the promoter's claims by a tax shelter promoter who, when requesting the ruling, left certain salient aspects of the transaction unrevealed. Thus, Revenue Procedure 74-17, 1974-1 Cumulative Bulletin at page 438, sets forth certain conditions for issuance of private rulings on this question. It provides that a favorable ruling will not ordinarily be issued unless, among other factors, the aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership. In this manner, Revenue Procedure 74-17 precludes the issuance of partnership classification rulings if the transaction involves a greater than one-to-one writeoff. Further, these and other private rulings state that no opinion is expressed as to the federal income tax consequences of the transaction except as specifically ruled upon.

In addition, to discourage the submission of carefully calculated incomplete statements of fact, Service procedures require taxpayers who request rulings on any issue to certify, under penalties of perjury, that the facts submitted in support of the ruling request represent a complete statement of all the facts relating to the transaction. If they do not, the ruling will be ineffective. Ruling letters are also caveated to note that they are directed only to the taxpayer who made the request and that they cannot be used or cited as precedent.

Mr. SHANNON. Well, maybe this is a starting point for us to try to come up with some kind of general accepted standards as to what is going to be ruled abusive and what isn't, do you think?

Mr. EGGER. Well, as I said before, we are doing our best to step up the number of published rulings that we issue in the shelter area so as to describe as fully as possible the various schemes that we think are abusive and to try to forewarn would-be investors.

Now, I can tell you that by just looking at the dozens of categories of rulings of shelter areas and trying to cover the waterfront is pretty difficult. So we feel that doing it by ruling rather than attemping to write a set of ground rules that will be universal is much more preferable.

Mr. SHANNON. Don't you think that knowledge that the Service has never issued a favorable ruling involving a greater than 1-to-1 writeoff is the sort of knowledge that would——

Mr. EGGER. If that is so, of course.

Mr. SHANNON. Would it be the sort of knowledge that would tend to discourage investors from getting involved in these kinds of tax shelters?

Mr. EGGER. Well, its bound to help, but I don't think that it will make the difference because there are court cases out there which have approved investments producing a different result and, of course, as the chief counsel mentioned a little bit ago, it is pretty well known that in the real estate area with no limitation on nonrecourse financing and so on that that is legally achievable.

Mr. SHANNON. If an individual files a tax return with the Internal Revenue Service, can that person escape civil and criminal liability connected with the return's deductions and other claims merely by filing an amended return?

Mr. EGGER. Not necessarily, no.

Mr. SHANNON. So, if a person was involved in what came to be characterized as an abusive tax shelter and that fact were publicized, that person does not necessarily escape civil or criminal liability merely by filing an amended return before the Service takes any action?

Mr. EGGER. Pretty clearly if the individual filed an amended return based on something that he hadn't known before and attempted to correct his tax liability long before we had ever even identified his return for examination, that would obviously be a factor in the criminal prosecution area. It wouldn't have too much of a bearing, necessarily, on the civil liability, certainly not on the interest and possibly not on the penalties as well.

Mr. SHANNON. Well, what if the filing of the amended return were based on nothing more than publicity attendant to the particular return?

Mr. EGGER. I am sorry.

Mr. SHANNON. If the investor or the filer of the return had taken advantage of this abusive tax shelter which was publicized, and as a result of that, prior to your taking any action, filed an amended return, how would you handle that?

Mr. EGGER. Well, if he filed an amended return then it would be a question of whether a negligence penalty, for example, applied. It is entirely likely that the so-called no-fault penalty would apply. Clearly the interest rules would apply since they are statutorily mandated.

Mr. SHANNON. What is the IRS's position with regard to the value of a note that doesn't carry an interest charge which is due some time long into the future?

Mr. EGGER. I think we are talking about the whole area of interest-free loans and that has a long history of litigation. Most of the cases in that area we have lost. Only recently the Court of Claims ruled in a case in our favor. That is to say, applying an income factor in that situation, but in the interest-free loans, most of them we have lost.

Mr. SHANNON. Well, do you need further legislation in that area to clarify the law?

Mr. EGGER. I don't know whether it is a question of needing additional legislation or not. The question, I suppose, is whether or not we are going to construct or reconstruct income in the interest-free

loan situation and if so, then Congress is going to have to consider that very carefully.

Mr. SHANNON. But if we could deal with this problem, we could define it more clearly for your purposes, wouldn't that cut down on the number of tax shelters? It might not cut down on the number of abusive tax shelters that are being used now?

Mr. EGGER. I don't think the interest-free loan is that much of a problem to us in the shelter area. Interest-free loans are more a fringe benefit kind of thing that employers provide and that happens between related members of the family and things of that kind.

Mr. SHANNON. Can an investor take the face value of this kind of debt as a deduction in the first year?

Mr. EGGER. Yes. Mr. Gideon just reminds me that that's the accrual problem that we were discussing earlier.

Mr. SHANNON. You ruled on this particular issue?

Mr. EGGER. We have taken positions on it.

Mr. SHANNON. In individual cases?

Mr. EGGER. I guess it is hard for me to answer that without more specific facts.

Mr. GIDEON. That is an area that we are concerned about, but it has ramifications that run the gamut of transactions from really all sorts of liabilities fixed now, but not actually paid until long into the future and they run through legitimate commercial transactions all the way into the shelter area and that is one of the reasons why we are having difficulty determining that the right answers ought to be in order to take a position in this area?

Mr. SHANNON. Well, isn't the tax issue that has to be considered whether or not the discounter can take present value when you take a deduction or whether you take a whole value in the first year?

Mr. GIDEON. Yes, I think that is right, but to just mention a case to show you how this can occur in settings that have nothing to do with shelters at all, a case that we recently lost in the Tax Court involves coal strip miners and whether they have the ability to accrue in the year that they dig the coal the expense that they are under State mandate to incur to restore the land in a later year. There are many permutations of the problem. As I say, it is under active study now and if we determine that we need legislation, we will be up here.

Mr. SHANNON. What bothers me, Mr. Commissioner, is not your effort in this area because I think it has been a very good effort in this area, but I think that we tend to come back to the bottom line that if we just had more compliance, if we just had more of an ability to review these cases, we would be able to deal with them. I really question as to whether or not there is legislative language which might be needed to absolutely prevent, in certain cases, the use of these types of techniques in tax preparation. You seem to say no, no substantive changes in the tax laws are required but, as you pointed out, you have been losing cases based on rulings meant to deal with these kinds of situations.

You have not ruled in other areas because of questions you might have. Maybe we should talk about some substantive changes in the law that will prevent these kinds of activities, prevent great-

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er than a 1-to-1 writeoff, prevent or define how these long-term low interest loans or no interest loans are going to be treated.

I just wonder whether you have any thoughts on that?

Mr. EGGER. Well, at the moment, we want to get into place procedures which can assimilate, and take full advantage of the massive changes that have already been made. Certainly there will be other areas that we will delve into and which will come out as specific needs as we go along.

The difficulty with trying to do something that is as broadly involved as what you are suggesting is we don't know what all of the side effects of it may be. And while we may eliminate one problem, we may wind up creating another and there just hasn't been enough time to study that kind of thing.

I did refer to the accrual method problem and yet knowing, as I do, that as soon as we begin to write rules about accounting methods in the Internal Revenue Code that they will have extremely far-reaching effects in other areas, legitimate business transactions.

Mr. SHANNON. Well, nobody wants to close down or create disincentive to legitimate business transactions, but I think we can all agree that there have been enormous abuses, as you have stated in your testimony. They have been widely embraced by the public, sought out by the public up to and including the Attorney General of the United States and we have got to do something about it. I just don't think that we can hope that tougher compliance measures or a bigger budget for the IRS or any of the other things that have been talked about can really solve the problem.

I think that we are going to have to really look at some of these substantive tax laws and make it clearer by law what is available to investors and what isn't under the law. And I would hope that we could work together on that.

Mr. EGGER. Well, I have certainly been pleased to work with a clear statement of exactly what is and what isn't permitted. But as I said before, when we start talking about what kind of things can be deducted against the difference or income from other sources and that sort of thing, that has tremendously far-reaching effects in the statute.

Mr. SHANNON. Mr. Commissioner, I would appreciate a written answer to the question on whether or not favorable rulings approving of a greater than 1-to-1 ratio have been allowed.

Mr. EGGER. Certainly.

[Reply to above question appears on p. 18.]

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman, and thank you also, Commissioner.

Along with Mr. Shannon's views and the questioning on the new laws, I understand that many of your agents don't like to be assigned tax shelter cases because they take a long time in closing them, and, they burn out. And, also, some of them have indicated, privately, that they have ways of correcting some of the tax shelter abuse, but that their input means nothing; that they could give some suggestions but there is no followup. It would appear to me that that is one thing that your law department or someone should get some input on. There have to be some changes that could be made in the law to correct some of this.

Mr. EGGER. Yes; to a greater or lesser degree, the assignment of agents to the tax shelter kind of task forces we have had in various districts has been frustrating. The inability to get information, the tremendously wide geographic spread of some of these promotions. The lack of cooperation that you get when we get into some of these areas that are certainly on the side of negligence, if not fraud, and the overall sense of frustration that a qualified agent feels has been a problem.

We think that to a very large extent the new partnership legislation, and I mentioned earlier our computer combined case control system that is now in place and is beginning to eliminate some of the problems of coordination, nationwide, all these things are helping in that respect.

Mr. DUNCAN. Could you have your staff to take a look at possible new legislation and, maybe, somebody might get them to the committee? I think we should followup on today's hearings. I think this is the most important hearing we have had by this committee this year. It could well be. Could you do that? Have your staff take another look at possible legislation?

Mr. EGGER. Certainly.

[The information follows:]

PROPOSALS FOR NEW LEGISLATION

As implied in an earlier response to Mr. Moore, the Service is still digesting the changes made by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and is not yet in a position to know whether any additional legislative changes are needed in the tax shelter area.

However, the Service is always alert for the need for such changes, and will recommend them through appropriate channels if deemed necessary.

Mr. DUNCAN. Do you think that we should have a system of registration for certain shelters and only allow tax deductions for registered shelters?

That has been suggested, I might say, by the New York State Bar Association. It clearly has a lot of merit to it.

Mr. EGGER. It is an extremely difficult area and one which I have not really discussed at all with the Treasury, but again, on the face of it, the code does anticipate that such things as the investment tax credit and the accelerated depreciation and so on will be incentives to investment and so one has to be extremely cautious in deciding just how you are going to limit those things because obviously those are the things on which many tax shelters are built as well.

So, one has to find out whether you can walk between the Scylla and the Charybdis, the good tax shelters and those that we deem to be abusive.

Mr. DUNCAN. Are the promoters likely to be located in certain parts of the country or is abuse spread throughout the country?

Mr. EGGER. I think we have a difference in various parts of the country.

We have, depending on the types of shelters, we see them in the large financial centers such as New York and so on. We also see them very, very heavily in the western region, southwest, and so on, and to a lesser extent in the New England area and so on.

I can't explain it. I don't even have a good working theory, but that is, nonetheless, the fact pattern.

Mr. DUNCAN. What effect would the flat-rate tax system have upon tax shelter abuses? I think a few months ago you indicated that you were studying that.

Mr. EGGER. Well, the Treasury is testifying on that very subject today, I believe, in the other House. I am not satisfied it would necessarily eliminate our problems. A great deal of the tax gap that I have talked about in the past arises from unreported income and I am not sure that would go away.

Mr. DUNCAN. Thank you very much. Thank you, Mr. Chairman.

Chairman RANGEL. Commissioner, I think Mr. Moore underscored my concern that there is a growing feeling in this country, that the wealthy are not paying their fair share of the taxes. Now it appears that investing in shelters is something chic. Everyone should have one and look forward to avoiding paying taxes. People are still marketing shelters, and I am not satisfied really that there has been a reversal of the trend that one should admire those people that are the wealthiest of this country that pay little or no tax.

Now, you put out some statistical data, the statistics of income. Doesn't that support the proposition that the wealthiest people in this country pay proportionately little or no taxes? I know you don't analyze your data, but isn't there reason for the average taxpayer to believe that you get a better shake when you are wealthy and can invest in these type of shelters?

Mr. EGGER. I think probably the statistics would bear out that the higher income people do, in fact, pay higher taxes. It's true that the investors in the shelter schemes do tend to the higher income levels, but recently we have done some very, very preliminary little surveys, nothing that could be statistically sound at all, but that have tended to indicate that the income level of shelter investors is coming down rather than the other direction.

Chairman RANGEL. Well, it means it is becoming more popoular.

Mr. EGGER. Yes.

Chairman RANGEL. Mr. Commissioner are you familiar with a list of the 400 wealthiest persons in the United States which was recently published in Forbes magazine?

Mr. EGGER. I don't identify it, Mr. Chairman.

Chairman RANGEL. Well, I am going to share it with the Service. We ought to find out whether or not there is any reason to believe that the wealthy in this country are not paying their fair share of the taxes and whether or not we have to wait until these tools catch up with the Service and whether or not we, as Members of Congress, should put in our newsletters how to avoid paying taxes under the latest IRS ruling. If it is going to be popular, then we all ought to get involved in it and it seems to be extremely popular since taxpayers don't know exactly what the risk is of getting caught.

Now, I am not trying to say you are not doing the best you can, but I am telling you as a fact that there does not generally seem to be much of a risk in taking your chances, sheltering your income and not paying taxes on it. This is especially true when we are

talking about people who are making investments with no hope of getting a return on that investment.

As a matter of fact, they get real uptight if they find out they may make some money on the investment. Then they have to reorganize their whole portfolio. That is wrong. We don't see enough cases in the newspaper that reflect what Justice is doing about it. We also haven't had time to see whether the new legislation is working. My only point is that as you popularize your slogans, you might try to find some way for someone to really believe that it is hazardous to one's wealth to abuse the tax laws and regulations. This committee wants to work with you on that and believe me, the Service has never had a reputation for being a Gestapo agency when it comes to rich people.

So if that keeps you awake at night, forget it. That is not where the image comes from.

Mr. EGGER. Well, we will certainly be pleased to work with the committee. I intend to go forward with publicizing this. I think it is fair to say that when we get away from Washington, the instances of tax fraud and prosecutions and so on do get a great deal more attention in the local press than is the case here or perhaps say in New York.

Chairman RANGEL. Are they published in the legal documents of these promoters when you get indictments and convictions? Do the promoters circulate it around?

Mr. EGGER. No, they don't circulate it. We do through our own clipping service. But I think what I am saying is that we have to have more sensitivity to that kind of thing in most areas around the country than sometimes we think here in this setting.

Chairman RANGEL. Well, thank you for your close cooperation with the committee and the Congress. If you have any ideas that perhaps were missed because we didn't raise the question, feel free to convey it to the members and staff.

Are there any other questions before the Commissioner leaves?

[No response.]

Chairman RANGEL. Thank you, again.

[The following was subsequently received:]

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C., Dec. 20, 1982.

Hon. CHARLES B. RANGEL,
Chairman, Subcommittee on Oversight,
Committee on Ways and Means, Washington, D.C.

DEAR MR. CHAIRMAN: As requested, I am enclosing our replies to the nine questions for the record you posed in your recent letter concerning abusive tax shelters.

I appreciated the opportunity to appear before you and the other members on this important topic, and can assure you that the Service plans to use the legislative tools in ERTA and TEFRA to the fullest in combatting abusive tax shelters.

You may be interested in a recent development that could impact our efforts in the shelter area. Criminal prosecution of abusive tax shelter promoters are typically brought in the jurisdiction where the scheme was packaged. Particularly in the larger cases, some of the defendants may reside in other jurisdictions. The Court of Appeals for the Ninth Circuit recently held in *United States* v. *Solomon* (decided October 13, 1982) that where the mails are used as part of the offense—such as to file tax returns—the defendants who did not reside in the district of the prosecution were entitled to have the substantive tax counts transferred to their district of residence. The court rejected the contrary holding of *United States* v. *Clemente*, 608 F.2d 76 (2d Cir., 1979), cert. denied, 466 U.S. 908 (1980), which found that a defendant was entitled to have the case transferred only when the government relied upon

use of the mails to change venue to a district other than where the defendant resided. This decision of the Ninth Circuit carries the prospect of two potentially lengthy trials instead of one. We currently have this matter under review in the Criminal Tax Division of Chief Counsel.

I look forward to continuing our productive relationship in the next Congress.

With best regards,

Sincerely,

ROSCOE EGGER, Jr.

Enclosure: As stated above.

Question 1. What steps is the IRS taking to clarify the correct amounts deductible as "at risk" in tax shelters involving low-interest or no-interest long-term debts? Is the IRS planning to issue a Revenue Ruling to clarify this situation? Are any statutory changes necessary to correct abuses in this area?

Response. The problem of determining the amount "at risk" under section 465 for low-interest or no-interest long-term debt is most apparent in two types of situations. The first involves a note given for something other than the purchase of property so that section 483, concerning imputed interest on deferred payments, does not apply. The second involves a note in which the payments of principal are recourse but the payments of interest are nonrecourse. The Service is studying the possibility of applying a present value theory to these notes either in the regulations under section 465 or in a revenue ruling.

Question 2. What more can the IRS do to alert potential investors of clearly "abusive" schemes? Without running afoul of the disclosure prohibitions of IRC Section 6103, would the IRS make available to the public, or at least to professionals admitted to practive before the IRS, a list of schemes and/or a list of promoters which have been previously found to be "abusive"?

Response. The Service has an active program to identify and disseminate to the media certain characteristics of what we believe to be abusive tax shelters. Such descriptions will not be identifiable to any particular taxpayer (in recognition of the confidentiality provisions of section 6103), but will aim to generally describe various similar shelters. The information will be distributed via periodic news releases.

Because of the restrictions on disclosure mandated by section 6103, we cannot identify promoters of abusive shelters if they are the subjects of open criminal investigations. However, once indicted or convicted, we can publicly identify these individuals. New section 7408, enacted by the Tax Equity and Fiscal Responsibility Act of 1982, will also aid the Service in making the public aware of who these promoters are. This section allows the Service to seek an injunction against a promoter who is subject to the abusive tax shelter penalty under new section 6700. Once an injunction is obtained, that individual can also be identified in public as the operator of an abusive shelter.

Question 3. With overvaluation of assets of a shelter being a primary feature of many abusive shelters, does IRS have enough qualified appraisers and experts, either as employees or on contract, to make professional and timely appraisals of such assets as real estate, movies, art works, mining properties, and computer software?

Response. We believe the Service has a sufficient number of qualified appraisers. Contract appraisals are used to supplement our valuations whenever our experts are not available or are not professionally qualified to appraise a specific asset.

Question 4. A survey of IRS tax shelter agents that was published in the June 11, 1981 issue of the National Treasury Employees Union Bulletin concluded that revenue agents are not pleased with the level of support or training which they receive. Many (46.6 percent) said they could not properly analyze and evaluate shelters to ascertain which are abusive and which are not. Many (48.8 percent) said they could not make an economic analysis of shelters and most (58.1 percent) said they could not do a present value analysis of a shelter. Please comment.

(a) What are you doing about their training?

(b) We understand that most agents do not want to work in "abusive" shelter cases because they cannot close the cases rapidly enough and they tend to "burn out" and become frustrated. Please comment on your evaluation of the current situation.

Response. Tax Shelter training is provided to revenue agents and tax auditors as part of their basic training. In addition, a special training course is provided to those examiners auditing abusive commodity shelters. As new schemes, tax law, and court decisions become available, examiners are alerted through our Continuing Professional Education training courses, which are continually revised and updated.

In addition, technical assistance is available on an as-needed basis from the Associate Chief Counsel (Technical). We have sixteen economists available who assist in evaluating the economics of a shelter, including present value analysis. We have also been able to obtain technical assistance in specialized areas, such as commodities, from other Government agencies, including the Commodity Futures Trading Commission.

Agents do become frustrated in examining tax shelters. Most tax shelter examinations involve uncooperative taxpayers and practitioners, and few if any books and records, so extensive third-party contacts are required. Additional administrative duties are also required in order to coordinate the examinations of the shelter and related investors. Both of these factors result in delays in closing the cases, which are difficult to close in any event, and contribute to a high frustration level among shelter examiners. However, we expect the "out-of-pocket" approach mentioned at the hearing, and the provisions of TEFRA dealing with abusive tax shelters and the tax treatment of partnership items to reduce this frustration.

Question 5. It is my understanding that typically half of the IRS's inventory of cases involving "abusive" shelters are from two regions (the Western and North Atlantic Regions).

(a) Do you believe all of your examiners and investigators have a sufficiently precise understanding of what an "abusive" shelter return is to assure that the same kinds of returns are designated as "abusive" in all IRS districts?

(b) What other factors account for some regions and districts having little examination activity in "abusive" shelter activities?

Response. As stated in our testimony at the September hearing, it can be difficult to define in a precise way what constitutes an "abusive tax shelter". Although the Internal Revenue Code does not define an abusive tax shelter, our Internal Revenue Manual does provide useful working definitions which guide Service personnel in making the determination of what is abusive. Ultimately, a factual analysis of the various components of a tax shelter is necessary to determine its basic nature. We are not aware of any problems in making such determinations.

We have various supplemental selection methods for helping to identify potentially abusive tax shelters. These computer systems use selected objective criteria from the tax returns. Once returns are computer identified, they are further screened by examiners who have experience in the tax shelter area. We are continually revising and perfecting our various selection methods for identifying potentially abusive tax shelters.

Experience has shown that shelters are generally marketed in the larger cities and financial centers around the country. We are as yet unable to determine what other factors may account for the large concentration of shelters in the Western and North Atlantic Regions.

Question 6. How will the new computer system help in auditing or tracking shelter returns? Will you be able to key into the big promoters? Will the computer be organized on a more national basis so that promoters won't be able to create delays and confusion by seeking out investors from different regions/districts?

Response. The Service has a number of computer enhancements under way which could eventually impact on the tax shelter area. However, the most relevant current effort is the Combined Case Control (CCC) System, a computer system that will aid in identifying related returns and controlling and tracking of abusive tax shelters. CCC will provide the capability to identify tax shelter schemes by promoters and disseminate this information in a national listing of promoters, schemes, and investors. This will alleviate some of the problems resulting from wide geographic dispersion of investors, including the employee frustration noted in Question 4.

Question 7. Should we have a system of registration for tax shelters and only allow tax deductions for registered shelters? (The New York State Bar Association Tax Section has suggested such an approach for "public" tax shelters with 10 or 25 investors.)

Response. While we have not performed a formal study of this proposal, our initial reaction is that it would be unworkable, because the number of tax shelters that would have to be "registered" would almost certainly pose a severe resource problem for the Service.

We are assuming that all prospectuses and related materials would have to be sent to the Service, where they would be reviewed and labeled as either "acceptable" or not. As we pointed out in our testimony at the September hearing, it is sometimes difficult to assemble all the relevant facts on a particular shelter issue. The assembly and review processes would inevitably require a great deal of time, largely because of the volume of materials we would expect to receive. Any delays would unnecessarily penalize the promoters of shelters ultimately found to be ac-

ceptable, although we assume such promoters would help expedite the process by their cooperation. Finally, we would have to establish some sort of appeals process by which those promoters whose shelters were found "unacceptable" could seek to reverse that finding.

The resources devoted to these functions would have to be taken from other existing functions, at a price to the overall effectiveness of the Service. Instead, we would perfer to rely on the legislative tools given us in ERTA and TEFRA as a means to attack abusive tax shelters, thus using our resources in what we believe are most efficient, proven ways.

Question 8. I am under the impression that only a small number (approximately 1,000) of shelter returns are referred by the IRS to the Justice Department each year. After that, only a portion of the cases are prosecuted. The Subcommittee was advised that only 36 cases have been successfully prosecuted by Justice in the last 3 years. Considering that almost all "abusive" tax shelter cases are identified and initially investigated by the IRS, I would like to have answers to the following:

(a) Exactly how many referrals (involving "abusive" tax shelters) were made to Justice 1978, 1979, 1981, and 1982?

Response: Our statistics indicate that there have been 469 shelter cases initiated for criminal investigations since fiscal year 1978. Statistics for 1978 are not available; following are statistics for fiscal years 1979, 1980, 1981, and 1982:

	Fiscal year				Total
	1979	1980	1981	1982	
Prosecution recommendations to the Department of Justice					
Declination of referred cases by:	29	28	62	100	219
Department of Justice	0	13	4	26	43
U.S. attorney	6	6	3	3	18
Indictments/information	4	7	39	40	90
Convictions	4	3	8	33	48

The majority of tax shelter criminal investigations are conducted by grand juries. All prosecution recommendations by Criminal Investigation of cases investigated by grand juries are referred to the Department irrespective of whether Counsel recommends for or against prosecution. Criminal Investigations normally recommends prosecution against promoters and/or operators of tax shelter schemes, rather than investors.

Question. (b) Why are so few cases attacked criminally?

Response. The number of prosecution recommendations in abusive shelter cases is primarily a reflection of the difficulty the Service has encountered in investigating what are, at best, complicated and time-consuming cases. The collusive, and sometimes conspiratorial, relationship between the promoters, investors, and third parties (e.g., engineers who provide inflated asset appraisals) makes it extremely difficult to obtain witnesses to establish the fraud. The use of tax haven countries with stringent bank secrecy laws further complicates the picture. These factors, and the delays and interference encountered in obtaining information by issuance of summonses, has resulted in most cases having to be investigated by grand juries, where subpoenas can be used and judicial immunity can be granted where appropriate. The increase in prosecution recommendations from 29 in fiscal year 1979 to 100 in fiscal year 1982, and the increase in indictments/information returned from 4 in fiscal year 1979 to 40 in fiscal year 1982, indicates that a number of these time-consuming investigations are now coming to fruition.

Question. (c) If, in the IRS' opinion, the cases referred to Justice should be prosecuted, why aren't they?

Response. Our Criminal Investigation Division forwards cases which the investigating Special Agent has recommended for prosecution. Department of Justice attorneys review them, and may decline to prosecute for a variety of reasons, such as weak testimony by witnesses, small amount of tax, determining responsibility, etc. The Internal Revenue Service and the Department of Justice forward cases with the highest degree of prosecution potential to the various United States Attorneys.

Question. (d) To what extent would more criminal prosecution be likely to deter the growing number of "abusive" shelter schemes?

Response. It is difficult to predict the specific deterrence that may be obtained from any particular level of criminal prosecutions. However, we believe that more

visibility in the criminal area would have a positive impact on tax compliance. The speed with which the Service responds to abusive shelters is as important to the promotion of tax compliance as the number of such responses. The Internal Revenue Service considers the prosecution of cases involving promotion of abusive tax shelters as an extremely important part of our tax enforcement program. Unscrupulous promoters of these illegal schemes enrich themselves while attacking at their source the revenues which support our government. Harsh treatment of such offenders is appropriate.

Question 9. You have stated that you estimated that abusive tax shelters cost the Treasury $3.6 billion a year in lost tax revenue. In the first 9 months of fiscal year 1982, the IRS assessed only about $613 million in additional taxes and penalties from examinations in the tax shelter program. Similarly, in all of fiscal year 1981 IRS assessed $594 million. Why is the amount assessed so much less than the $3.6 billion estimate?

Response. The $3.6 billion estimate was a projection based on 1979 TCMP data on one abusive tax shelter area (commodities). While rough, this is still a good estimate of the overall size of the problem.

Our assessments to date are relatively modest due to the problems noted earlier—complex cases, a lack of books and records, uncooperative taxpayers and practitioners, and so on. Under these conditions, and lacking proper legislative tools, it takes a great deal of time and effort to develop, work, and close these cases.

However, progress is being made. The $594 million in recommended assessments for fiscal year 1981 and the $967 million in recommended assessments for fiscal year 1982 resulted from examination closings of 49,474 returns and 74,710 returns, respectively. After these closings, IRS still has approximately 300,000 returns in progress involving nearly $4 billion. These returns are being actively worked, and our efforts will result in additional recommended assessments. We expect the "out-of-pocket expenses" approach, mentioned at the hearing, together with the increased resources requested for fiscal year 1983 and the relevant provisions of TEFRA, to help us make significant strides in reducing the size of the problem.

PHILADELPHIA, PA., *October 12, 1982.*

Re House Ways and Means Committee on Oversight: Abusive Tax Shelters.

Representative CHARLES RANGEL,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN RANGEL: I recently attended the hearings chaired by you on Tuesday, September 28, regarding the abusive tax shelters. At that time specific recommendations were made by various witnesses concerning proposals to help curb abusive tax shelters.

Your inquiry, however, centered on whether the public would know the tax shelter program is being enforced and whether all Americans are paying their fair share. I submit to you that at the present time the only way the public will ever know is through newspaper publicity. The purpose of this letter, however, is to suggest that at least the tax practioners in the country might be offered effective assistance from the government in evaluating whether or not any of their clients should invest in purportedly "abusive" tax shelters. I am specifically referring to the fact that if a tax shelter is presented to me for analysis, I am unable to ascertain from either the Securities and Exchange Commission, the United States Attorney's Office, the Internal Revenue Service or any agency of the Department of Justice as to whether any of the persons involved in the transaction have ever been indicted, or subject to any kind of sanction. As you know, these items are a matter of public record. Notwithstanding, no agency of the government cooperates with the private sector in making this information available.

The effect of allowing this information to be available, and I might add readily available, would be to allow a more personal evaluation of the persons involved in the offering and ascertain whether they have good reputations. For example, if an individual has been subject to SEC or IRS enforcement action, such information should be disclosed to the investor since it certainly bears on the promoter's character. Often times, however, the prospectus does not make note of this information or downplays it and does not indicate the severity with which either agency may have dealt with the promoter. The availability of this type of information could severely

crimp promoters who have in the past entered into many kinds of questionable transactions and continue to do so.

Thank you very much.

Very truly yours,

MICHAEL E. MARKOVITZ,
Attorney at Law.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C., December 28, 1982.

Hon. CHARLES B. RANGEL,
House of Representatives,
Washington, D.C.

DEAR MR. RANGEL: Thank you for your letter dated November 24, 1982, in which you forwarded Mr. Michael Markovitz's suggestions to help curb abusive tax shelters.

The Internal Revenue Service has an active program to identify and disseminate to the media certain characteristics of what we believe to be abusive tax shelters. Particular taxpayers will not be identifiable from these descriptions (in recognition of the confidentiality provisions of section 6103 of the Internal Revenue Code). The information will describe various similar shelters in general terms and will be distributed via periodic news releases.

Because of the restrictions on disclosure mandated by section 6103 of the Code, we cannot identify promoters of abusive shelters if they are the subjects of open criminal investigations. However, once indicted or convicted, we can publicly identify these individuals. New section 7408, enacted by the Tax Equity and Fiscal Responsibility Act of 1982, will also aid the Service in making the public aware of who these promoters are. Section 7408 provides that the Service can seek an injunction against a promoter who is subject to the abusive tax shelter penalty under section 6700. Once an injunction is obtained, that promoter can also be identified in public as the operator of an abusive shelter.

I hope this information will be useful to you, and if we can be of any more assistance to you, please let us know.

With kind regards,

Sincerely,

ROSCOE EGGER.

[Editor's note.—For response from Securities and Exchange Commission, see letter of John M. Fedders, December 14, 1982.]

Chairman RANGEL. Glenn L. Archer, Jr., Assistant Attorney General, Tax Division, Department of Justice. Mr. Archer, you heard many of the questions asked by the committee. We have your testimony. You can respond to some of those questions or proceed as you find convenient.

STATEMENT OF GLENN L. ARCHER, JR., ASSISTANT ATTORNEY GENERAL, TAX DIVISION, DEPARTMENT OF JUSTICE

Mr. ARCHER. Mr. Chairman and members of the subcommittee, if it is acceptable, I would like to read at least part of my prepared statement and ask that the statement be included in the record.

Chairman RANGEL. The full statement will appear in the record without objection.

Mr. ARCHER. I appreciate your inviting me to participate in your examination of the issues surrounding the use of abusive tax shelters.

In the tax shelter area, the Justice Department has been involved almost exclusively with fraudulent, illegal promotions or investment schemes. Our role on the civil side has been limited. Tax shelter investors typically seek deferral of taxes and have no interest in making the immediate payment necessary to commence a tax refund suit. Thus, virtually all of the tax shelter civil litigation has been brought in the Tax Court where taxpayers can take advantage of the additional deferral period accorded by procedures applicable to Tax Court cases.

We believe that vigorous enforcement action is essential both with respect to fraudulent tax schemes and other illegal tax shelters to maintain the integrity of our self-assessment system of taxation and in fairness to those who voluntarily comply with our tax laws. The sense of being fairly treated appears to have eroded somewhat in the last few years. The diminished confidence in the tax system has been caused at least in part by promoters of fraudulent tax shelters. Indeed, the attention given to the availability of tax shelters has given rise to a number of illegal tax schemes in which the targets are members of the working class, such as mail-order ministries and family equity trust packages. Schemes of this nature are also the focus of a number of criminal prosecutions brought by the Department.

The detection, selection and the development of criminal tax cases is primarily the responsiblity of the IRS. The Tax Division of the Justice Department is responsible for prosecutions and grand jury investigations of tax offenses and supervision over prosecutions and investigations conducted by the U.S. attorneys. In doing so, we seek to apply uniform national standards to tax prosecutions.

Most criminal tax cases are referred by the Service to the Justice Department only after the investigation has been completed by the Service administratively and at the time of referral the Service recommends prosecution. Where tax shelters are involved, the Service has encountered extreme difficulty in bringing criminal investigations to a conclusion using its administrative tools. The result is that a much higher percentage of these cases are forwarded to us with a recommendation for investigation by a grand jury. Proof of criminal intent is often difficult, if not impossible, without the cooperation of a person who participated in development of the scheme and we have found that such persons are more likely to cooperate when testifying before a grand jury under a grant of immunity. In addition, some of the transactions are so complex that obtaining documentary evidence through issuance of administrative summonses is too cumbersome, and the best means of securing the evidence is through a grand jury investigation. Even then, securing all of the necessary evidence cannot be assured. In some of the more widely marketed schemes, sophisticated promoters, with the aid of their advisors, create fictitious transactions with multiple entities through offshore tax haven banks in countries with strict bank secrecy laws. Obtaining evidence of the true nature of these transactions is fraught with difficulty.

As a general rule, the focus of a criminal case is on persons who organize, package and sell tax shelter schemes, rather than on the investors. The reason for this is that the proof of criminal intent is usually impossible in the case of an investor who is not directly involved in organization and implementation of the scheme. Opinion letters prepared by tax advisors are often distributed as part of the offering and are intended to provide investors with a type of "fraud insurance"—insulation against criminal liability and civil fraud penalties. In other situations the investors themselves are being defrauded where, for example, the underlying assets of the shelter do not exist or are not acquired for the investors.

When a criminal tax case is being processed, the Service will customarily withhold efforts to assess and collect the tax civilly. The concern is that our efforts on the criminal side not be impaired. In tax shelter cases, however, we have found it necesssary to modify this usual approach because the statute of limitations on assessment of the taxes owing by the investors might well expire during the pendency of a criminal case against the promoter with the result that these taxes would be rendered uncollectible. To avoid this substantial loss of revenues, we have agreed that the Service can and should proceed civilly against the investors, despite the simultaneous pursuit of a criminal case against the promoter, so long as there is no direct conflict with the criminal case.

The illegal tax shelter schemes which the Justice Department has investigated or for which prosecutions have been brought have involved a broad array of investment and financial arrangements. Many widely marketed, legitimate tax shelter investments have illegitimate counterparts, distinguishable only by the fraudulent actions of the promoters. Our cases have involved, for example, real estate ventures; tax shelters involving coal; oil and gas ventures; investments in cattle, agricultural crops and horticultural products; equipment leasing; investments in art work; commodities transactions; research and development shelters; and gold and silver transactions. Some examples of our recent cases are set out in an appendix to this statement.

The nature of the fraud or deceit presented in these schemes varies. Some involve fictitious loans between sham corporations to create deductible interest or intangible drilling expenses; fraudulent overvaluations of investments; illusory transactions between paper offshore entities to create partnership deductions; backdating of documents; and investments in nonexistent assets.

While the Government has had notable successes in criminal prosecutions of shelter promoters, these types of cases are not without significant problems. The transactions are often extremely complex; the true facts are disguised and are uncovered only after tedious investigation of multiple entities; and the potential witnesses and documentation are often scattered throughout the United States or even overseas—frequently in tax haven countries with stringent bank secrecy laws. As I mentioned earlier, evidence in a bank secrecy jurisdiction may be completely out of reach of the Service and our prosecutors. Even when the bank secrecy laws have exceptions for certain crimes, tax fraud often does not receive the favored treatment. Each prosecution of a major scheme in the shelter area involves a major outlay of resources, both by the Internal Revenue Service and the Department of Justice, in the investigation, preparation, and trial of the case.

One serious drawback of using the criminal sanction against shelter promoters is the timelag between commission of the offense and conviction of the defendant. The delay permits the unscrupulous promoter to continue his illegal activities while under investigation for a previous offense. Moreover, prosecution is feasible only in the most extreme cases. If the legality of the scheme is reasonably debatable, the prosecution will be unable to prove the existence of criminal intent beyond a reasonable doubt. Thus, a wide

range of abusive tax shelter activities is completely beyond the reach of the criminal sanctions.

Turning from the criminal side to the civil side, the Congress has recognized the existence of overreaching in the tax shelter area and has taken a number of constructive steps to address the problem. The first step was the enactment of the at-risk rules by the Tax Reform Act of 1976 and their extension to a broader range of activities by the Revenue Act of 1978. Tax losses can no longer be claimed except to the extent of the taxpayer's actual economic investment in the venture. As a result of amendments made by the Economic Recovery Tax Act [ERTA], the at-risk rules now apply to claims for investment tax credits as well. Enactment of these limitations on artificial tax benefits has had an ironic effect. The irony is that the fraudulent part of many tax shelters currently marketed represents an effort on the part of the promoter to circumvent the at-risk rules, frequently by means of offshore entities.

There are civil penalties and procedural devices in the Tax Equity and Fiscal Responsibility Act which will have the effect of creating economic risk for the promoters and new financial risk for the investors in shelter schemes. From the perspective of the Justice Department, the most significant of the changes made by TEFRA involves the new procedure for obtaining injunctions against promoters of abusive tax shelters, which is also coupled with a new penalty on such promoters.

The aggressive marketing of fraudulent or abusive tax shelters typically involves false representations concerning the availability of tax benefits or gross overvaluations of property or services, the value of which is directly related to the availability of tax benefits. Under these circumstances, the court is authorized to enjoin not only continuation of the abusive shelter activity at issue, but also any other acts which would be subject to penalty for promoting abusive shelters. Thus, the injunction could prevent the promoter from organizing and selling new abusive tax shelter schemes.

I have had discussions with the Chief Counsel of the Internal Revenue Service concerning implementation of the authority to seek injunctions against tax shelter promoters and the IRS is now attempting to identify cases in which it would be appropriate to seek such relief. The Justice Department has pledged its complete cooperation in the vigorous use of this new compliance tool.

Although the injunction approach has great promise, it will not be a practical alternative in some of the larger and most complicated schemes. The same problems which plague criminal investigations will be present and the investigation of such cases through a grand jury will not be available. Thus, where highly sophisticated schemes with multiple sham entities and offshore transactions are involved, the criminal sanction may still be the only viable alternative.

In addition to the penalty and injunction provisions relating to abusive promotions, TEFRA enacted a penalty for substantial understatements, new code section 6661, which should have a beneficial effect on the Service's efforts to police the tax shelter area. Under prior law, there was virtually no incentive to discourage the taking of extremely aggressive positions on a tax return by the in-

vestor except for the overvaluation penalty recently enacted by ERTA.

Code section 6661 now builds into the tax system a financial risk factor for taking questionable positions on a return, which result in a substantial understatement of income tax. Unless a tax shelter investor can prove the existence of a reasonable belief that the position taken on the return was more likely than not correct, a penalty of 10 percent of the understatement will be imposed.

Two other provisions of the Tax Equity and Fiscal Responsibility Act are also relevant. I anticipate that the new partnership audit provisions will be of significant assistance both to the Service and the Tax Court in the management of tax shelter audits and litigation where partnerships are the vehicle for the investment. Moreover, I hope and expect that the enhanced criminal penalties for the major tax offenses will have a beneficial deterrent effect on all tax fraud, particularly the wide-scale fraud committed by means of illegal tax shelter schemes.

Your letter requesting me to appear asked for any legislative suggestions which we might have in connection with abusive tax shelters. We are pleased with the compliance measures recently enacted and look forward to their implementation. Until we have had an opportunity to evaluate the effects of these new tools, we are not in a position to suggest further legislation.

I would be pleased to respond to any questions that you might have.

[The prepared statement follows:]

STATEMENT OF GLENN L. ARCHER, JR., ASSISTANT ATTORNEY GENERAL, TAX DIVISION, DEPARTMENT OF JUSTICE

Mr. Chairman and Members of the Subcommittee, thank you for inviting me to participate in your examination of issues surrounding the use of "abusive" tax shelters.

In the tax shelter area, the Justice Department has been involved almost exclusively with fraudulent, illegal promotions or investment schemes. Our role on the civil side has been limited. Tax shelter investors typically seek deferral of taxes and have no interest in making the immediate payment necessary to commence a tax refund suit. Thus, virtually all of the tax shelter civil litigation has been brought in the Tax Court where taxpayers can take advantage of the additional deferral period accorded by procedures applicable to Tax Court cases.

Vigorous enforcement action is essential both with respect to fraudulent tax schemes and other illegal tax shelters to maintain the integrity of our self-assessment system of taxation and in fairness to those who voluntarily comply with our tax laws. The sense of being fairly treated appears to have eroded somewhat in the last few years. The diminished confidence in the tax system has been caused at least in part by promoters of fraudulent tax shelters. Indeed, the attention given to the availability of tax shelters has given rise to a number of illegal tax schemes in which the targets are members of the working class, such as mail-order ministries and family equity trust packages. Schemes of this nature are also the focus of a number of criminal prosecutions brought by the Department.

The detection, selection and the development of criminal tax cases is primarily the responsibility of the IRS. The Tax Division of the Justice Department is responsible for prosecutions and grand jury investigations of tax offenses and supervision over prosecutions and investigations conducted by the United States Attorneys. In doing so, we seek to apply uniform national standards to tax prosecutions. In the tax shelter area, we consult frequently with the Service concerning investigative and prosecutive standards and we also have found it essential to consult with the Securities and Exchange Commission and the Fraud Section of the Criminal Division of the Justice Department.

Most criminal tax cases are referred by the Service to the Justice Department only after the investigation has been completed by the Service administratively and

at the time of referral the Service recommends prosecution. Where tax shelters are involved, the Service has encountered extreme difficulty in bringing criminal investigations to a conclusion using its administrative tools. The result is that a much higher percentage of these cases are forwarded to us with a recommendation for investigation by a grand jury. Proof of criminal intent is often difficult, if not impossible, without the cooperation of a person who participated in development of the scheme and we have found that such persons are more likely to cooperate when testifying before a grand jury under a grant of immunity. In addition, some of the transactions are so complex that obtaining documentary evidence through issuance of administrative summonses is too cumbersome, and the best means of securing the evidence is through a grand jury investigation. Even then, securing all of the necessary evidence cannot be assured. In some of the more widely marketed schemes, sophisticated promoters, with the aid of their advisors, create fictitious transactions with multiple entities through offshore tax haven banks in countries with strict bank secrecy laws. Obtaining evidence of the true nature of these transactions is fraught with difficulty.

As a general rule, the focus of a criminal case is on persons who organize, package and sell tax shelter schemes, rather than on the investors. The reason for this is that the proof of criminal intent is usually impossible in the case of an investor who is not directly involved in organization and implementation of the scheme. Opinion letters prepared by tax advisors are often distributed as part of the offering and are intended to provide investors with a type of "fraud insurance"—insulation against criminal liability and civil fraud penalties. In other situations, the investors themselves are being defrauded where, for example, the underlying assets of the shelter do not exist or are not acquired for the investors.

When a criminal tax case is being processed, the Service will customarily withhold efforts to assess and collect the taxes civilly. The concern is that our efforts on the criminal side not be impaired. In tax shelter cases, however, we have found it necessary to modify this usual approach because the statute of limitations on assessment of the taxes owing by the investors might well expire during the pendency of a criminal case against the promoter with the result that these taxes would be rendered uncollectible. To avoid this substantial loss of revenues, we have agreed that the Service can and should proceed civilly against the investors, despite the simultaneous pursuit of a criminal case against the promoter, so long as there is no direct conflict with the criminal case.

The illegal tax shelter schemes which the Justice Department has investigated or for which prosecutions have been brought have involved a broad array of investment and financial arrangements. Many widely marketed, legitimate tax shelter investments have illegitimate counterparts, distinguishable only by the fraudulent actions of the promoters. Our cases have involved, for example, real estate ventures; tax shelters involving coal; oil and gas ventures; investments in cattle, agricultural crops and horticultural products; equipment leasing; investments in art work; commodities transactions; research and development shelters; and gold and silver transactions. Some examples of our recent cases are set out in an Appendix to this statement. Other examples of typical schemes were discussed in earlier hearings before this Subcommittee. "Offshore Tax Havens: Hearings before the Subcommittee on Oversight, House Committee on Ways and Means," 96th Cong., 1st Sess. (April 24 and 25, 1979).

Fraudulent tax shelters are frequently designed so that they appear to take advantage of special tax benefits provided by the Internal Revenue Code. The complexity of the Code and the size of the special tax advantages for certain types of privileged activity breed extraordinarily complicated criminal transactions cloaked in an appearance of legitimacy. The aim of the promoters is simple—to disguise the transactions as merely aggressive tax planning. To distinguish between the legitimate and the illicit is sometimes difficult. And, as long as legitimate tax shelter transactions are possible, there will be at least some fraudulent tax shelters.

The nature of the fraud or deceit presented in these schemes varies. Some involve fictitious loans between sham corporations to create "deductible" interest or intangible drilling expenses; fraudulent overvaluations of investments; illusory transactions between paper offshore entities to create partnership deductions; backdating of documents; and "investments" in nonexistent assets.

While the Government has had notable successes in criminal prosecutions of shelter promoters, these types of cases are not without significant problems. The transactions are often extremely complex; the true facts are disguised and are uncovered only after tedious investigation of multiple entities; and the potential witnesses and documentation are often scattered throughout the United States or even overseas—frequently in tax haven countries with stringent bank secrecy laws. As I mentioned

earlier, evidence in a bank secrecy jurisdiction may be completely out of reach of the Service and our prosecutors. Even when the bank secrecy laws have exceptions for certain crimes, tax fraud often does not receive the favored treatment. Each prosecution of a major scheme in the shelter area involves a major outlay of resources, both by the Internal Revenue Service and the Department of Justice, in the investigation, preparation and trial of the case.

Despite these problems, the Tax Division considers the prosecution of cases involving promotion of fraudulent tax shelters as an extremely important part of our tax enforcement program. Unscrupulous promoters of these illegal schemes enrich themselves, while attacking at its source the revenues which support our Government by causing numerous false returns to be filed. Stern sentencing of such offenders is appropriate. Judges often recognize the seriousness of these offenses and impose significant prison terms. In two recent cases, for example, defendants were sentenced to jail terms of eight years.

One serious drawback of using the criminal sanction against shelter promoters is the time-lag between commission of the offense and conviction of the defendant. The marshalling of evidence needed to prove guilt beyond a reasonable doubt is extraordinarily time-consuming and the promoter may not be brought to justice for several years after commission of the offense. The delay permits the unscrupulous promoter to continue his illegal activities while under investigation for a previous offense. Moreover, prosecution is feasible only in the most extreme cases. If the legality of the scheme is reasonably debatable, the prosecution will be unable to prove the existence of ciminal intent beyond a reasonable doubt. Thus, a wide range of abusive tax shelter activities is completely beyond the reach of the criminal sanctions.

Turning from the criminal side to the civil side, the Congress has recognized the existence of overreaching in the tax shelter area and has taken a number of constructive steps to address the problem. The first step was the enactment of the "at risk" rules by the Tax Reform Act of 1976 and their extension to a broader range of activities by the Revenue Act of 1978. Tax losses can no longer be claimed except to the extent of the taxpayer's actual economic investment in the venture. As a result of amendments made by the Economic Recovery Tax Act (ERTA), the at risk rules now apply to claims for investment tax credits as well. Enactment of these limitations on artificial tax benefits has had one ironic effect. The irony is that the fraudulent part of many tax shelters currently marketed represents an effort on the part of the promoter to circumvent the at risk rules, frequently by means of offshore entities.

ERTA also made tax shelters that rely upon questionable appraisals much less attractive to investors by enacting a new overvaluation penalty. In addition, the negligence penalty was increased.

New civil penalties and procedural devices which will have the effect of creating economic risk for promoters and a new financial risk for investors in shelter schemes were enacted by the Tax Equity and Fiscal Responsibility Act (TEFRA). From the perspective of the Justice Department, the most significant of the changes made by TEFRA involves the new procedure for obtaining injunctions against promoters of abusive tax shelters, which is coupled with a new penalty on such promoters.[1] The injunction procedure represents an extension and a broadening of authority which has been available under Code Sections 7402 and 7407 to enjoin fraudulent acts of tax return preparers.[2]

The aggressive marketing of fraudulent or abusive tax shelters typically involves false representations concerning the availability of tax benefits or gross overvaluations of property or services, the value of which is directly related to the availability of tax benefits. Under these circumstances, the court is authorized to enjoin not only continuation of the abusive shelter activity at issue, but also any other acts which would be subject to the penalty for promoting abusive shelters. Thus, the injunction could prevent the promoter from organizing and selling new abusive tax shelter schemes.

I have had discussions with the Chief Counsel of the Internal Revenue Service concerning implementation of the authority to seek injunctions against tax shelter promoters and the IRS is now attempting to identify cases in which it would be ap-

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[1] The IRS can impose an assessable penalty of $1,000 or 10 percent of the gross income to be derived from the offering, if greater.

[2] In this connection, it should be noted that the Court of Appeals for the Eighth Circuit in *United States* v. *Landsberger*, 82-2 U.S.T.C. par. 9497 (July 29, 1982), recently affirmed the entry by the district court of a permanent injunction against a return preparer from making misleading representations to taxpayers in the promotion of a tax scheme known as the foreign tax haven double trust.

propriate to seek such relief. The Justice Department has pledged its complete cooperation in the vigorous use of this new compliance tool. The ability to close down an illegal shelter scheme by obtaining an injunction will permit us to react more quickly to transparent or otherwise deceptive schemes and prevent the continuation of the fraud on the public fisc. The entry of an injunction also has an immediate deterrent effect on the promoter: violation of the court's injunctive order exposes him to possible immediate sanctions. While the Service must investigate and refer a case before suit is brought, I anticipate that a number of injunction suits against promoters will be brought in the next several months.

Although the injunction approach has great promise, it will not be a practical alternative in some of the larger and most complicated schemes. The same problems which plague criminal investigations will be present and the investigation of such cases through a grand jury will not be available. Thus, where highly sophisticated schemes with multiple sham entities and offshore transactions are involved, the criminal sanction may still be the only viable alternative.

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Code Section 6661 now builds into the tax system a financial risk factor for taking questionable positions on a return, which result in a substantial understatement of income tax. Unless a tax shelter investor can prove the existence of a reasonable belief that the position taken on the return was more likely than not correct, a penalty of 10 percent of the understatement will be imposed.[3] This new sanction should reduce the incentive to invest in borderline schemes.[4]

Two other provisions of the Tax Equity and Fiscal Responsibility Act are also relevant. I anticipate that the new partnership audit provisions will be of significant assistance both to the Service and the Tax Court in the management of tax shelter audits and litigation where partnerships are the vehicle for the investment. Moreover, I hope and expect that the enhanced criminal penalties for the major tax offenses will have a beneficial deterrent effect on all tax fraud, particularly the wide-scale fraud committed by means of illegal tax shelter schemes.

Your letter requesting me to appear asked for any legislative suggestions which we might have in connection with abusive tax shelters. We are pleased with the compliance measures recently enacted and look forward to their implementation. Until we have had an opportunity to evaluate the effects of these new tools, we are not in a position to suggest further measures.

I would be pleased to respond to any questions that you might have.

APPENDIX—EXAMPLES OF SOME RECENT CRIMINAL TAX CASES INVOLVING ABUSIVE TAX SHELTERS

1. *United States* v. *Dahlstrom, et al.* In January 1982, following a 29-day jury trial in the District Court in Washington State, five promoters of fraudulent foreign trusts were convicted of conspiracy to defraud the United States (18 U.S.C. 371) and of 16 substantive counts of aiding and assisting in the preparation of false individual income tax returns (26 U.S.C. 7206(2)). The defendants sold a package of preprinted forms for a substantial fee and advised and counseled taxpayers to enter into a series of sham transactions with foreign trusts, which were to be established in either the Turks and Caicos Islands, British West Indies or Belize. These transactions involved the transfer and leaseback of "tax education packages." It is estimated that approximately 700 packages were sold and utilized nationwide, resulting in tens of millions of dollars of potential loss to the Government. The principal defendant was sentenced to five years' imprisonment and fined $35,000, while the other four defendants' sentences varied from one to four years.

2. *United States* v. *Badger.* In September 1981, in Utah, the promoter of a fraudulent oil and gas tax shelter, which utilized fictitious loans among sham corporations to create over four million dollars of fraudulent partnership deductions in the form of interest and intangible drilling expenses, was convicted of conspiring to defraud

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[3] Where tax shelter issues are not involved, the penalty may be avoided upon proof that the taxpayer had reason to believe there was substantial authority for the position taken or upon adequate disclosure on the return concerning the item.

[4] The attractiveness of deferral has been diminished by the new rules on interest computations enacted by ERTA and TEFRA.

the United States by impeding and impairing the lawful function of the Internal Revenue Service (18 U.S.C. 371), and was sentenced to five years' imprisonment.

3. *United States* v. *Whipple, et al.* In November 1981, also in Utah, three defendants, who promoted and sold fraudulent movie tax shelters to more than 200 limited partners, were convicted on charges of aiding and assisting in the preparation of false partnership and investor returns. In December 1981, the main promoter was sentenced to prison for three years and the others were sentenced to probation. The motion picture tax shelters, operated and sold as limited partnerships, were marketed in California and Utah from 1974 through 1980. A number of schemes were employed, including the fraudulent valuation of the motion pictures, and the use of illusory transactions between sham entities in Andorra and the Cayman Islands, to create millions of dollars of fraudulent partnership expenditures and the resultant deductions for U.S. taxpayers.

4. *United States* v. *Carruth and Reed.* In January 1982, another fraudulent shelter involving the syndication of approximately 117 limited partnerships which owned overstated cattle herds was successfully prosecuted. A district court judge in California handed out three-year prison terms to the promoter and the operator of the herd. Illusory financing and cattle feed expenses were created by passing worthless checks among controlled entities in the U.S. and Canada; based on those sham transactions, investors received a multiple write-off of three dollars for every dollar invested.

5. *United States* v. *Osserman, et al.* In December 1981, in Massachusetts, four defendants pled guilty to felonies arising out of a major fraudulent coal tax shelter program involving backdated agreements and offshore entities. Two were lawyers and promoters, and two others were major administrators and promoters. A fifth individual, who was a salesman, pled guilty earlier. The fraudulent shelter generated an estimated 100 million dollars in deductions to investors with a resultant tax loss of 35 million for one year. The two lawyers were sentenced to serve one year each in jail followed by three years' probation during which they were to perform 2,500 hours of public service. The two other defendants received six months' imprisonment each and two and one-half years' probation and the requirement that they serve 2,000 hours of public service.

Nine other defendants, including five lawyers, were also charged in the indictment with felonies for participation in the scheme and were prosecuted in a trial lasting 55 days. At the conclusion of the Government's case, the judge ruled that there was insufficient evidence to send the case to the jury and acquitted these defendants. Among the factors which led to the acquittal are the complexity of the scheme; the large number of defendants, which made presentation of the case difficult; the protracted nature of the trial; and the fact that the four major promoters had already been convicted.

6. *United States* v. *Duffell.* In August 1982, the District Court in the Central District of California sentenced a thirty-four year old tax shelter promoter to six years' imprisonment for Title 18 and Title 26 U.S.C. offenses arising out of an illegal scheme involving approximately 160 limited partnerships and more than 1,200 investors. The defendant caused losses estimated at eleven million dollars to the U.S. Treasury through his actions in falsely claiming to have used investor funds for the purchase of tractor trailers and related expenses.

7. *United States* v. *Flomenhoft.* In June 1982, a jury in Chicago, Illinois, found a practicing attorney guilty of 61 counts of mail fraud and two counts of 26 U.S.C. 7206(1) for preparing false returns of limited partnerships in connection with an illegal coal mine tax shelter. He was recently sentenced to eight years' incarceration. The defendant's conviction resulted from his scheme to claim deductions after the effective date of changes in the applicable law and regulations pertaining to coal mining. The false deductions generated by this scheme were approximately twelve million dollars.

8. *United States* v. *Loney.* In September 1982, the District Court in the Eastern District of Washington found an attorney guilty of a violation of 26 U.S.C. 7206(1) for claiming business losses on his individual tax return, in part, arising out of a nonexistent partnership. This ostensible partnership was claimed by the defendant to have been part of oil and gas tax shelter investments he was promoting. The defendant is awaiting sentencing.

9. *United States* v. *Siegel and Winograd.* In January 1981, a jury in the Northern District of Illinois convicted two defendants of conspiracy and aiding in the preparation of false tax returns in violation of 26 U.S.C. 7206(2) in connection with "rigged" commodity tax straddles. The defendants utilized their positions as "brokers" to create fictitious short-term losses through sham commodity trades. The defendants

were fined in excess of $500,000. The Government proved that over one million dollars in losses were generated through "rigged" commodity futures trades.

10. *United States* v. *Bonastia, et al.* In September and October 1981, three defendants pled guilty to mail fraud, conspiracy, and tax offenses in the District of New Jersey. The defendants were engaged in the syndication of limited partnership tax shelters to purchase and operate various types of improved real properties. However, all funds received from investors in approximately 130 partnerships were not used to acquire the properties and all of the partnerships did not own a piece of real estate. The defendants were sentenced to incarceration, probation and fines.

11. *United States* v. *Neal, Jeffers and Winters.* In December 1980, in the Southern District of West Virginia, two promoters of a coal tax shelter were convicted of conspiracy and assisting in the preparation of false tax returns. A third defendant pled guilty. The Government's evidence established that the evaluation of the available coal reserves was falsified by the promoters. The three defendants were sentenced to various periods of incarceration.

12. *United States* v. *Parker.* In February 1982, in the District of Colorado, the defendant pled guilty to one count of mail fraud (18 U.S.C. 1341), one count of wire fraud (18 U.S.C. 1343), one count of assisting in the preparation of false tax returns (26 U.S.C. 7206(2)), one count of failing to file an individual tax return (26 U.S.C. 7203) and one count of perjury (18 U.S.C. 1621). The defendant is a promoter of tax shelters that allegedly involved gold mines in two foreign countries. He was sentenced to eight years' incarceration and has agreed to make restitution of eight million dollars that he collected from investors.

Chairman RANGEL. Thank you, Mr. Archer.

Why were there so few indictments and prosecutions? The figure that was given to me was hard to believe. I think you had 36 cases in 3 years.

I am not talking about the quality of the cases. It is just hard to believe that there would be so few successful prosecutions.

Mr. ARCHER. I think there may be several factors involved there. One, of course, is the quality of the prosecutions.

Chairman RANGEL. Thirty-six cases in thirty-six months is kind of difficult for the average lawmaker to understand, assuming that we do have widespread fraud in this area. Are you saying that you didn't have enough resources or the cases are too complex or you just prosecute what is turned over to you? Is there some reason why there are so few? The IRS believes there are so many abuses, it seems that there would be a larger percentage of criminal cases in that big abusive category.

Mr. ARCHER. If I may, Mr. Chairman, there are several factors which have contributed to this. One which the Commissioner indicated in this testimony is that in the initial stages of tax shelter promotions, the promoters were stretching the law, but not really violating the law. As the at-risk rules of the 1976 act were enacted and extended now what we are seeing is more of the really illegal shelters, and those have just started to come in the pipeline. I think that the Commissioner indicated that the IRS has something in the nature of 200 current investigations.

Chairman RANGEL. Do you rely totally on the Service for the cases that you take to the grand jury?

Mr. ARCHER. We rely almost exclusively on the IRS. The U.S. attorneys, the Criminal Division of the Justice Department, the FBI, and the SEC will all be investigating fraud in general, and refer to the Tax Division some cases that involve potential tax crimes, so that we have cases initiated through other agencies besides the Internal Revenue Service. But for the most part, we depend on the investigative resources from the Internal Revenue Service for the cases that come to the Tax Division.

Chairman RANGEL. From a law enforcement view, do you believe that we are finding more violations of the Federal law in this area or less?

What percentage of your regular caseload are these illegal tax shelters?

Mr. ARCHER. I don't have a specific figure as to the percentage of our caseload that would involve the illegal shelters. We are devoting increased attention to the problem in the Tax Division. We have a relatively small criminal section within the Tax Division, as I think you may know. Recently, almost 20 percent of the investigations and prosecutions of cases that the Tax Division handles directly involve tax shelters.

Chairman RANGEL. But basically, if it does not come from the Service, chances are it will not be picked up by Justice?

Mr. ARCHER. Not unless it is investigated, as I mentioned, by the U.S. attorneys, Criminal Division, the FBI, or SEC as a fraud transaction.

Chairman RANGEL. Have you ever investigated or indicted or convicted an investor in a tax shelter, as opposed to the promoter?

Mr. ARCHER. We have only proceeded against the investors to date if they were actively involved in the promotion of the particular illegal shelter or were otherwise aware of the fraudulent conduct. It is very difficult to prove criminal intent when they have opinion letters and are relying on professional advisers.

Chairman RANGEL. So you have a good working relationship with IRS and there is no need for any additional legislation? You are satisfied with the track record of the Department of Justice with regard to illegal shelters?

Mr. ARCHER. As Mr. Gideon pointed out in his brief statement, we are consulting on a regular basis with the Internal Revenue Service on the specific problems, trying to work out ways in which we can conduct less intensive investigations and bring them to criminal prosecution at a much earlier date, as well as coordinating on the traditional methods of investigating shelters.

We are consulting with respect to the new injunctive procedures and will very shortly begin to target specific cases for bringing injunctive actions.

Chairman RANGEL. Justice will be doing this on its own initiative?

Mr. ARCHER. These will be cases, again, in which the Internal Revenue Service investigates sufficiently to lay a foundation for an injunctive action and then the Tax Division will prosecute the civil injunction proceeding.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I have no questions.

Chairman RANGEL. Mr. Pease.

Mr. PEASE. Thank you very much, Mr. Chairman.

Mr. Archer, we hear that the usual tax shelter cases are very difficult to prosecute criminally. Could you explain to me as a novice why that is the case?

Mr. ARCHER. Well, there are probably several reasons that they are difficult to prosecute.

First and foremost, is that very often they involve multiple defendants.

Mr. PEASE. Multiple what, sir?

Mr. ARCHER. Multiple defendants.

In other words, there are usually several people involved in a particular promotion and each defendant would have his own attorney, and during the course of the prosecution the trial would tend to drag out when you have that many lawyers involved in it, as you might suspect.

Another problem is the difficulty of explaining to a jury fraud as opposed to what might be considered a legitimate transaction.

Now, there are some cases where you have clear badges of fraud which are not too difficult to prosecute. But in other cases where you get into excessive overvaluation questions or where you get into complex offshore transactions or flows of money between related entities, these are very difficult cases to get across to the jury. Nevertheless, I think that the Department has had a good record in its prosecutions of tax shelter cases although, as the chairman indicated, there have not been a substantial number of cases. And I think that the sentencing that we are beginning to get in these cases from the judges indicates that we are doing a good job in prosecuting these cases.

Mr. PEASE. Mr. Archer, how many people do you have in the Justice Department working on such cases?

Mr. ARCHER. In the Tax Division we have a total of about 60 lawyers in our criminal section and of those approximately 10 lawyers have significant work in the tax shelter area reviewing cases, prosecuting cases, or conducting grand jury investigations.

I might add that the Criminal Division of the Department of Justice has its own fraud section. They have conducted investigations with the FBI into some frauds. There have been some SEC frauds that have been handled by the fraud section of the Criminal Division, all of which involve the tax shelter area. So there are not only our people working on it, but people in other branches of the Department of Justice that are aware of and are working on the problem.

Mr. PEASE. Keeping in mind the figures you just gave me, 10 people are working specifically on the use of the shelters. How would those figures compare with the figure from, say, 3 years ago?

Mr. ARCHER. I don't have those figures in my hands but I think it would be more today than it was 3 years ago.

Mr. PEASE. More in each case? More totally in your division and more working on tax abuse?

Mr. ARCHER. I think that is right.

Mr. PEASE. Does the Justice Department take the position that a favorable reasonable basis opinion letter from the law firm on a tax shelter absolves all limited partner investors of any criminal liability?

Mr. ARCHER. As I mentioned, we do not usually prosecute an investor separately. In other words, the investor had to be involved in the organization or promotion or otherwise aware of the fraud before we prosecuted any investor. And the reason for that is just what you are suggesting, that it is very difficult to prove criminal

intent on the part of an investor where there have been letters from professional advisers opining on the tax consequences.

Mr. PEASE. Do you ever prosecute the advisers for giving out that kind of advice?

Mr. ARCHER. We have prosecuted a number of advisers as a part of our criminal prosecutions, several lawyers and accountants.

I might also say that appraisers in some cases have been prosecuted.

Mr. PEASE. We used to talk in the tax area about the chilling effect of certain actions by the Federal Government. If there were some kind of action or possible penalty on the investors themselves, wouldn't that have a chilling effect in terms of proliferation of these shelters?

Mr. ARCHER. Well, as the Commissioner pointed out and as I touched on in my testimony, the Congress did provide some civil penalties in the TEFRA legislation this year that will affect investors and cause a much greater degree of financial risk for the investors.

There are also time-sensitive negligence penalties and interest is going to be compounding on a daily basis against the investors in shelters if their deductions are disallowed.

Mr. PEASE. Staff has called to our attention a case which the Justice Department just lost in a district court in Massachusetts following the Wyoming coal mining venture, 1,200 investors which allegedly lost the U.S. Treasury $35 million in 1976; $35 million is a lot of money.

I compare that with the 10 people who are working to prevent such abusive shelters.

The administration earlier this year recommended the hiring of a substantial number of additional IRS agents on the theory that the outlays would be exceeded to a great extent by the increased revenues that the agents would bring in.

Is there that sort of possibility in connection with the abusive tax shelters also?

Mr. ARCHER. I think that there is that possibility that the resources of the U.S. attorneys and the Tax Division are somewhat strained today with budget constraints and that additional resources probably would be of some help.

Mr. PEASE. Well, I know the current administration does not like to have Federal employees on the payroll, but it seems to me that if you have not 10 but rather 20 or 50 or 100 lawyers working in this area that you might be able to bring more cases to court and win the cases and pay the salaries of the lawyers several times over, and that the increased activity in this area would have, as I mentioned before, the appropriate chilling effect on the concoction of new abusive tax shelters.

Does that seem feasible and logical to you?

Mr. ARCHER. That seems feasible and logical; yes.

Mr. PEASE. I am glad that we are in agreement on that point. Thank you very much, Mr. Archer.

Chairman RANGEL. Well, I don't want to get you in any political trouble but your response to Mr. Pease just makes a lot of sense. We are all trying to do the best we can. If, in fact, it would help to balance the budget by bringing in more revenues, I hope you can

find some way to get that proposal in. It just seems to me that whether we are talking about the Service or whether we are talking about Justice, we are losing a lot of money out there and obviously it is because we don't have the proper technical resources.

Mr. ARCHER. I think it is fair to say that the Tax Division and the U.S. attorneys have been able to keep up with the number of the cases that have been referred to us to the present time. But I think, as indicated in the Commissioner's testimony——

Chairman RANGEL. I don't know about Justice, but certainly not the Service. Justice may have because you prosecute so few. However, the Service has a backlog which I hope the new tools will help alleviate, but the Service stays in deep trouble and they can't even ask for new people. Congress has to shove it down their throat and then they say thank you.

I don't know how Justice functions, but we are losing a lot of money. If you are satisfied that additional resources would help us handle the problem—maybe you can have one of your staff people get in touch with us and outline how that goal could best be accomplished.

Mr. ARCHER. As the Commissioner indicated, the number of these fraudulent shelters is increasing as a result of the changes in law—there are now more restrictions on tax shelters. And we may see a significant increase in the number of criminal cases that are developed by the Internal Revenue Service and sent to us in the Tax Division for prosecution or investigation by a grand jury in the coming months and years here.

Chairman RANGEL. Well, the number you handle is so small that I hesitate to ask about it. How many shelter cases do you have pending?

Mr. ARCHER. We have currently, according to our statistics, 42 grand jury investigations or cases where the grand jury has been completed and we are reviewing the cases. The number of targets is at least 70. Some of these grand jury investigations are in the early stages so we don't have a full scope of the number of targets.

Chairman RANGEL. How many convictions have you had this year?

Mr. ARCHER. I don't have those figures right before me.

Chairman RANGEL. In the last 12 months?

Mr. ARCHER. Could we furnish that to the committee?

Chairman RANGEL. My point was that in the last 3 years there have been very, very few convictions, and it is just hard to impress upon the public that you just didn't have that many cases that came in front of you and that there should not have been more cases in front of you.

This is especially true when people are losing confidence in government generally.

Now, unless you are prepared to say that you don't believe that convictions are necessary in this area, I just don't know what we are going to use as the criteria.

Mr. ARCHER. I believe they are necessary, but I think it is a matter of developing these cases and getting them to prosecution.

Chairman RANGEL. In view of the national problem, are you satisfied that the Justice Department's track record regarding investigations, grand jury investigations, indictments, and convictions is

satisfactory? Are you satisfied that our Government is doing the best it can for the Justice Department?

Mr. ARCHER. Based on my brief experience in government, I think that we are making, indeed, good progress toward increasing the number of these cases. We are learning the techniques of how to ferret out the cases better and I think that there will be a significant number of prosecutions in the future.

Chairman RANGEL. You can share with me that statistical data regarding the number and kind of cases and the number of convictions that you have had. Then maybe we will have a better understanding as to why it is so difficult to prosecute these cases.

Mr. ARCHER. Yes, sir.

[The following was subsequently received:]

The Chairman asked for information concerning the number of criminal tax cases involving tax shelters during the last fiscal year. Our records reflect that in the 1982 fiscal year, indictments were returned against 48 individuals and convictions were obtained against 33 individuals in criminal tax cases involving tax shelters.

Chairman RANGEL. Are there any other questions from the committee?

[No response.]

Chairman RANGEL. Thank you.

John Fedders, Director of the Division of Enforcement, Securities and Exchange Commission.

STATEMENT OF JOHN M. FEDDERS, DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY CHARLES A. BAER, ATTORNEY

Mr. FEDDERS. Good morning, Mr. Chairman.

Chairman RANGEL. You can proceed and have your testimony entered into the record or proceed as you find convenient.

Mr. Fedders is the Director of Enforcement.

Mr. FEDDERS. I have a 10-page written statement. I would prefer that it be put into the record in full. I would also like to deliver some summary statements to you.

To my right is Mr. Charles Baer, expert in the tax shelter area.

If the chairman would give me some idea as to how much of a good thing that he would like as a summary, would you like me to go on for 5 minutes?

Chairman RANGEL. Five minutes would be fine and then perhaps we can get a better handle on the questions.

Mr. FEDDERS. I appreciate the opportunity to testify on behalf of the Securities and Exchange Commission with respect to issues relating to abusive tax shelters.

The activities of the Commission with respect to tax shelters stem primarily from its statutory responsibility to enforce the registration and antifraud provisions of the Federal securities laws.

In this context the Federal securities laws have two distinct objectives. One, to assure that investors are provided certain information involving securities offered for sale to the public and; two, to prohibit fraud in the offer and sale of securities.

Many of the Commission's enforcement actions with respect to tax shelters involve a failure to comply with the registration re-

quirements of the Securities Act of 1933 or the criteria set forth in various exemptions.

In the past, the Commission has often found that claims of reliance upon exemptions from the registration requirements are not, in fact, valid.

The Commission also is responsible for the prevention and suppression of fraud in connection with transactions in securities. The general antifraud provisions of the Federal securities laws are contained in section 17(a) of the Securities Act of 1933. Section 10(b) of the Securities Exchange Act of 1934 and rule 10(b)(5) promulgated under the latter act.

While the Commission's highest enforcement priorities are cases involving (1) fraud by reporting companies; (2) financial statement fraud; (3) the manipulation of the trading of securities; (4) broker-dealer practices and supervision; and (5) insider trading, the Commission has a continuing interest in acting against violations in connection with the offer and sale of interest in tax shelters.

Chairman John S. R. Shad and the other Commissioners intend for the Securities and Exchange Commission to maintain an enforcement presence in the tax shelter area and the Commission will be better able to do so if the legislative proposal I will suggest is enacted.

I have set forth at the bottom of page 3 of my written remarks a number of the areas of potential fraud in connection with investments and I will reserve those for the reading of the committee.

The Commission staff obtains information concerning abusive tax shelters from a number of sources. Included among these are the Internal Revenue Service, State securities administrators, and the National Association of Securities Dealers, Inc. We have every intention to continue to investigate tax shelter programs and to prosecute enforcement actions against tax-sheltered enterprises, particularly their principals and promoters where they fail to comply with the registration and antifraud provisions of the Federal securities laws.

I have set forth at pages 4, 5, and 6 of my written statement several of the cases and principal areas that the Commission has been involved in in the recent past.

I would now like to focus, in conclusion, upon problem areas for the Commission with respect to tax shelters. Investors have few guideposts for differentiating between legitimate programs for tax avoidance and abusive schemes which offer bogus deductions. Because tax shelter programs are often sold during the holiday rush before the end of the calendar tax year, investors do not always consider the danger warnings that do exist.

Accordingly, the Commission has placed particular emphasis in this enforcement program upon deterring violative conduct by the promoters of tax shelters and those who assist their promotional efforts.

The Commission faces special difficulties in acting against fraud in the sale of tax shelter securities. In most cases of fraud, victims are eager to cooperate in the Government's prosecution of the defrauder. However, the Commission often finds that investors in tax shelters are concerned that cooperation with the Securities and Exchange Commission may lead to the disallowance of claimed tax

benefits. This is particularly true when it already is apparent that the tax shelter enterprise will not be profitable. Therefore, the Commission cannot expect the same level of investor cooperation that is typical in other types of fraud investigations.

Prior to 1977, the Commission was one of the three most frequent users of tax information for investigative purposes.

On January 1, 1977, section 6103 of the Internal Revenue Code took effect. That section limits access to two classes of information in the hands of the IRS. It limits the Commission's access (1) to tax returns and other information furnished by or on behalf of the taxpayer which relate to possible tax liability, and (2) other information relating to possible tax liability.

Since 1977, the Commission has made no request for the first type of information and only one request for the second type.

The Securities and Exchange Commission does not object to those provisions of section 6103 that limit access to information provided to the IRS by or on behalf of taxpayers that relates to their possible tax liability.

However, the Commission has substantial concerns regarding the present restrictions on obtaining information from the IRS.

Those concerns are based upon questions regarding (1) the proper legal interpretation of section 6103; (2) the procedures required to safeguard information that might be obtained from the IRS; and (3) certain negative consequences to the Commission if it obtains such information.

I want to briefly describe the types of information the Commission believes it should be able to obtain from the IRS more freely.

We are not seeking tax returns and other information furnished by taxpayers concerning their tax liability. However, it would assist our law enforcement efforts in the tax shelter area to have better access of other information presently covered by section 6103.

In the typical abusive tax shelter case, the Commission will obtain documents, affidavits, and investigative testimony from those persons who have knowledge or information regarding possible violation of the Federal securities laws including promoters, counsel who prepare tax opinions, accountants who conduct audits of the issuer and underwriters and their counsel.

Most of the investigative information gathered in these cases, which is usually voluminous, does not come from the taxpayer investor. Moreover, the IRS often obtains exactly the same type of information as the Commission when it conducts an investigation of possible violations of the tax laws and regulations.

The inability of the Commission to obtain and use such other information after it has been obtained in an IRS investigation may force the Commission to expend its limited resources in duplicative investigatory work or to turn its attention to other matters where the anticipated expenditure of resources may yield greater benefits to the investigating public. Set forth on pages 8 and 9 of my prepared statement are some of the steps that the Internal Revenue Service requires the Commission to go through in order to obtain that information and preserve that information after it has been obtained.

I understand that a major purpose served by the Tax Reform Act of 1976 was to assure taxpayers that information that they provided the IRS in connection with their tax liabilities would not likely be provided to other agencies of government.

That policy is not applicable when dealing with information of the type sought by the Securities and Exchange Commission.

Accordingly, there does not appear to be a compelling reason why the Commission should be required to duplicate an IRS investigation to obtain third party information and other information not provided by or on behalf of a taxpayer.

In conclusion, I believe the Congress should consider amending section 6103 to allow the Securities and Exchange Commission to obtain from the Internal Revenue Service information concerning a taxpayer that is not provided to the IRS by the taxpayer or a person acting on his behalf and to use such information in all commissioned proceedings to enforce the Federal securities laws.

Thank you, and I would be glad to answer any questions that you have.

[The prepared statement follows:]

STATEMENT OF JOHN M. FEDDERS, DIRECTOR, DIVISION OF ENFORCEMENT OF THE SECURITIES AND EXCHANGE COMMISSION

I. INTRODUCTION

I appreciate the opportunity to testify on behalf of the Securities and Exchange Commission with respect to issues relating to "abusive" tax shelters. "Abusive" tax shelters include investment schemes which claim tax benefits beyond those intended by law or which have little or no economic reality. The promoters of such tax shelters often exaggerate the value of the assets or business involved or make materially false or misleading statements to investors.

The law permits tax shelters to exist because Congress has deemed it important to encourage investments in certain kinds of enterprises. Thus, although a major incentive for investing in a tax sheltered enterprise may be the prospect of a tax deduction, the investment must have "economic substance" apart from any tax advantages in order to qualify for a tax deduction. *See e.g. Knetsch* v. *U.S.*, 348 F.2d 932 (Ct. Cl.), *cert. denied*, 383 U.S. 957 (1966). A tax shelter may involve an investment in oil and gas wells, coal mines, the raising of cattle, the production of motion picture films or other enterprises.

From an investor's perspective, there are a number of distinct inducements to invest in a tax shelter—leverage, deferral or conversion. First, there is the prospect of a substantial tax deduction or credits which may be used to reduce one's current tax liability. Second, if the venture proves to be successful, the investor may realize substantial profits. Third, the investor's profits may be treated as capital gains rather than ordinary income.

II. THE ROLE OF THE COMMISSION

The activities of the Securities and Exchange Commission with respect to tax shelters stem primarily from its statutory responsibility to enforce the registration and antifraud provisions of the federal securities laws. In this context, the federal securities laws have two distinct objectives: (i) to assure that investors are provided certain information concerning securities that are offered for sale to the public and (ii) to prohibit fraud in the offer and sale of securities.

The offer and sale of interests in a tax sheltered enterprise may constitute a public offering of securities that is subject to the registration requirements of the Securities Act of 1933. For example, interests in a tax sheltered enterprise often constitute securities in the form of "investment contracts." As the Supreme Court pointed out in *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 298 (1946), an "investment contract" exists where individuals are "led to invest money in a common enterprise with the expectation that they would earn a profit solely from the efforts of the promoter or someone other than themselves."

To the extent investments in tax sheltered enterprises involve the offer and sale of securities, the Securities Act of 1933 and Commission rules promulgated thereunder are designed to assure that investors are provided adequate information to make a reasoned investment decision. Such offerings must either be registered with the Commission or made pursuant to a valid claim of exemption. Possible exemptions are available for private placements of securities, for intrastate offerings and for certain offerings that either involve a relatively small amount of capital or are otherwise of a limited character. In this regard, on March 8, 1982 the Commission promulgated Regulation D which consolidated and replaced the limited offering exemptions contained in former Commission Rules 240 and 242 and the private offering exemption set forth in former Rule 146. (In fiscal year 1981, there were 485 tax shelter offerings registered with the Commission. In addition, there were about 6,800 offerings exempt from registration pursuant to the Commission's Rule 146, many of which were tax shelters.)

Many of the Commission's enforcement actions with respect to tax shelters involve a failure to comply with the registration requirements of the Securities Act of 1933 or the criteria set forth in various exemptions. In the past, the Commission has often found that claims of reliance upon exemptions from the registration requirements are not, in fact, valid.

The Commission also is responsible for the prevention and supression of fraud in connection with transactions in securities. The general antifraud provisions of the federal securities laws are contained in Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated under the latter Act.

While the Commission's highest enforcement priorities are cases involving (i) fraud by reporting companies, (ii) financial statement fraud, (iii) the manipulation of the trading of securities, (iv) broker-dealer sales practices and supervision, and (v) insider trading, the Commission has a continuing interest in acting against violations in connection with the offer and sale of interests in tax shelters. In February 1980, former Commission Chairman Harold M. Williams, in testimony before a subcommittee of the House Committee on Appropriations, included tax shelter securities as one of 17 areas to which the Commission would devote enforcement resources. Chairman John S. R. Shad and the other Commissioners intend for the Commission to maintain an enforcement presence in the tax shelter area, and the Commission will be better able to do so if a legislative proposal I will suggest is enacted.

There are a number of areas of potential fraud in connection with tax sheltered investments. For example, promoters of a tax shelter may make materially false or misleading statements regarding the tax consequences of the investment. There may be a failure to disclose commingling of the proceeds of one offering with those of another. There may be a failure to provide adequate disclosure of the payments or other compensation provided to promoters or others associated with the enterprise. The promoters may simply convert investor funds to their own use. The underlying enterprise in which the investment is made may be a sham rather than a legitimate venture. There may be misstatements of the value of the assets to be acquired by the enterprise and misleading projections of the income to be generated by those assets. There may be a failure to disclose the speculative nature of the program. The promoters may make false statements concerning their background, or may fail to disclose past episodes of illegal conduct. They may make false claims as to the identity of other investors in the project, or falsely claim to have invested in the project themselves. There may be misstatements concerning the status of the sale of the offering or the probability that sufficient money will be raised for the investment to go forward. Promoters also may make false statements concerning their ability to obtain necessary government permits, licenses or clearances required to proceed with a project. These examples reflect principle areas of potential fraud.

The Commission's staff obtains information concerning abusive tax shelters from a number of sources. For example, it examines the filings of small and exempt offerings and develops leads from the information contained in the filings. It also may obtain leads from newspaper ads and investor complaints. In addition, the Commission obtains information from state securities administrators and The National Association of Securities Dealers, Inc., a self-regulatory organization of broker-dealers estabished pursuant to the Securities Exchange Act of 1934. (The NASD is developing a special set of rules for broker-dealers regarding sale of "Direct Participation Programs", NASD Manual ¶2191, Article III, Section 34 of the NASD Rules of Fair Practice, which include most tax shelters.)

When appropriate, the Commission refers cases to state securities administrators and to the NASD. It also has participated with the NASD and the states in other forms of mutual law enforcement cooperation in this area.

The Commission will continue to investigate tax shelter programs and prosecute enforcement actions against tax sheltered enterprises, and their principles and promoters, when they fail to comply with the registration and antifraud provisions of the federal securities laws. As in the other areas of its enforcement program, the Commission pursues cases on a selective basis. An important consideration is the effect that the enforcement action, the entry of an injunction and decree containing such equitable relief as may be appropriate, will have in deterring possible future violations of the securities laws.

The Commission also will continue to proceed against securities professionals, such as brokers and dealers, and against attorneys and accountants, who participate in, or aid and abet, fraud in the sale of tax shelter programs or failures to comply with the registration requirements. Securities industry professionals who sell interests in tax shelters can give promoters access to their clients, and are often trusted advisors to those clients. In addition, the opinion supplied by the promoter's tax attorney is often the critical element in sales of tax shelters. Even if the opinion is qualified, investors may view the opinion as insurance against the assessment of a penalty for fraud by the Internal Revenue Service. By including culpable attorneys, accountants and securities industry professionals in its enforcement actions, the Commission seeks to prevent a repetition of violative conduct by those involved and to deter others from engaging in similar illegal conduct.

III. EXAMPLES OF RECENT COMMISSION ENFORCEMENT ACTIONS

I will discuss several recent Commission enforcement actions in the tax shelter area.

One enforcement action involved the sale of limited partnership interests by the promoters of the "Flowerland" partnership tax shelters to more than 2,377 investors in exchange for approximately 40 million in cash. The various partnerships formed an interrelated business that was purported to engage in growing and marketing horticultural products.

The Commission brought a civil injunctive action alleging that the promoters made false statements regarding tax deductions available to investors and misappropriated substantially all of the investors' cash contributions. In November 1980, a final judgment of permanent injunction was issued against the defendants. A special agent was appointed to manage the defendant companies. *S.E.C.* v. *Edward H. Heller*, Civil Action No. 80-2[illegible], November 10, 1980).

In addition, the tax counsel for various limited partnerships consented to the entry of a court-ordered permanent injunction barring him from rendering opinions on securities and tax issues and from practicing before the Commission, with a right to apply for relief from portion of the decree after five years. Among other things, the Court's order also required that, on receiving inquiries from investors, the attorney must furnish them with court papers filed in the action. *S.E.C.* v. *Robert Adler*, Civil Action No. 80-2830 (D.D.C., November 5, 1980).

An example of the Commission's close cooperation with other federal agencies, the NASD and state securities regulators in the tax shelter area is *SEC* v. *Cal-Am Corporation*, Civil Action No. 77-4586-AAH (C.D. Cal., August 11, 1980). Cal-Am Corporation formed numerous limited partnerships which offered investments initially in resort condominiums and later in coal leases. The various partnerships raised over $37 million.

The Commission's complaint alleged that millions of dollars were used for the personal benefit of the promoters. An attorney in the case was alleged to have falsely assured investors that certain of the programs met the criteria of the IRS for deducting advance mineral royalty payments. The Commission obtained permanent injunctions against future violative conduct by Cal-Am Corporation, the major promoters and the attorney.

In this case, the IRS disallowed the claimed deductions and is preparing to litigate the issue in the Tax Court. Several of the promoters were subjects of a 96 count indictment charging mail fraud, conspiracy to commit securities fraud, submission of false tax documents to the IRS and aiding and abetting the filing of false tax returns. In addition, the NASD brought some 30 cases against broker-dealers and securities salesmen for violation of securities laws and the NASD's rules in connection with the case, and the California Department of Corporations prosecuted a civil action.

Another recent tax shelter enforcement case was *SEC* v. *The International Mining Exchange, Inc.*, 515 F. Supp. 1062 (D. Col., 1981). The promoters of that scheme offered a "gold tax shelter investment program". The U.S. District Court for Colorado found that the defendants represented that investors would realize a federal income tax deduction equal to 500% of their investment and the potential for substantial profits from gold in the mines, even though such a tax deduction would be impermissible because the company did not incur the development expenses required by the rules and regulations of the IRS. The Court permanently enjoined The International Mining Exchange, Inc. and its controlling person from violating the registration and anti-fraud provisions of the federal securities laws.

IV. PROBLEM AREAS FOR THE COMMISSION WITH RESPECT TO TAX SHELTERS

Investors have few guideposts for differentiating between legitimate programs for tax avoidance and abusive schemes which offer bogus deductions. Because tax shelter programs are often sold during the holiday rush before the end of the calendar tax year, investors do not always consider the danger warnings that do exist. Accordingly, the Commission has placed particular emphasis in its enforcement program upon deterring violative conduct by the promoters of tax shelters and those who assist their promotional efforts.

The Commission faces special difficulties in acting against fraud in the sale of tax shelter securities. In most cases of fraud, victims are eager to cooperate in the government's prosecution of the defrauder. However, the Commission often finds that investors in tax shelters are concerned that cooperation with the Commission may lead to the disallowance of claimed tax benefits. This is particularly true when it already is apparent that the tax shelter enterprise will not be profitable. Therefore, the Commission cannot expect the same level of investor cooperation that is typical in other types of fraud investigations.

The Commission's Division of Enforcement and the Division of Corporation Finance cooperate with and provide information to the IRS in its pursuit of abusive tax shelter schemes. However, the Commission has experienced difficulty in obtaining information from the IRS. This statement is not intended to reflect adversely on the dedicated members of the IRS staff.

Prior to 1977 the Commission was one of the three most frequent users of tax information for investigative purposes. On January 1, 1977, Section 6103 of the Internal Revenue Code, added by the Tax Reform Act of 1976, took effect. Section 6103 limits access to two classes of information in the hands of the IRS: (i) tax returns and other information furnished by or on behalf of the taxpayer which relate to possible tax liability and (ii) other information relating to possible tax liability. Since 1977 the Commission has made no requests for the first type of information and only one request for the second type.

The Commission does not object to those provisions of Section 6103 that limit access to information provided to the IRS by or on behalf of taxpayers that relates to their possible tax liability. However, the Commission has substantial concerns regarding the present restrictions on obtaining other information from the IRS. Those concerns are based upon questions regarding (i) the proper legal interpretation of Section 6103, (ii) the procedures required to safeguard information that might be obtained from the IRS, and (iii) certain negative consequences to the Commission if it obtains such information.

I want to describe the type of information the Commission believes it should be able to obtain from the IRS more freely. We are not seeking tax returns and other information furnished by taxpayers concerning their tax liability. However, it would assist our law enforcement efforts in the tax shelter area to have better access to the "other information" presently covered by Section 6103.

In the typical abusive tax shelter case, the Commission will obtain documents, affidavits, and investigative testimony from those persons who have knowledge or information regarding possible violations of the securities laws, including promoters, counsel who prepare tax opinions, accountants who conduct audits of the issuer, and underwriters and their counsel. Most of the investigative information gathered in these cases, which is usually voluminous, does not come from the taxpayer investors. Moreover, the IRS often obtains exactly the same type of information as the Commission when it conducts an investigation of possible violations of the tax laws and regulations. The inability of the Commission to obtain and use such "other information," after it has been obtained in an IRS investigation, may force the Commission to expend its limited resources in duplicative investigative work or to turn its attention to other matters where the anticipated expenditure of resources may yield greater benefits to the investing public.

Section 6103 provides that in order for the Commission's staff to obtain access to information, other than that provided by or on behalf of a taxpayer, the Commission must be engaged in a proceeding (or in an investigation which may result in a proceeding) "pertaining to the enforcement of a . . . Federal criminal statute." Further, any information so obtained may be used as evidence only in an "administrative or judicial proceeding pertaining to the enforcement of a . . . Federal criminal statute." Although many Commission investigations could lead to criminal prosecution because willful violation of the securities laws carries criminal penalties, it is often impossible in the early stages of an investigation to predict whether a particular investigation will lead to a criminal action or to a civil injunctive or administrative proceeding. In any event, the statute, as interpreted by the IRS, precludes the Commission from obtaining or using such information in connection with Commission injunctive actions, which are the Commission's principal enforcement tool. The Commission cannot initiate a criminal action.

The Commission also has difficulty with the standards set by the IRS for safeguarding information which the Commission may obtain from the IRS. For example, the IRS requires that, within one month of its receipt of information, the Commission must send the IRS a report including, among other information: (i) names of appropriate officials, (ii) copies of statutes pursuant to which the agency requests the information, (iii) a chart of the agency's structure and a chart or description of the flow of tax data through the agency, including delegation orders permitting use of tax data by subordinate officials, (iv) a determination of whether tax data is commingled with other data, and (v) copies of written procedures which, at a minimum, describe the physical security afforded such data, the procedure for disposing of such information, agency computer capabilities and the agency's security awareness program. The IRS also requires an annual report to be signed by the head of the agency or other person agreed to by the IRS. The report must include: (i) changes in procedures for complying with IRS requirements and in access to IRS information, (ii) results of internal inspections regarding compliance with safeguard procedures, including offices visited and findings, and (iii) a report on tax information disposed of, which is adequate to identify the material destroyed and date and manner of destruction. These requirements are in addition to the Commission's existing statutory and procedural requirements that investigative information be kept confidential.

While the Commission can understand the need for stringent safeguards for tax returns and material provided by taxpayers, the Commission questions the need for special additional protections for the other information developed by the IRS in its investigations. These requirements serve to inhibit law enforcement cooperation with respect to abusive tax shelters.

A further concern arises from the great number of occasions on which the Commission, in its civil injunctive actions, is forced to engage in protracted and difficult litigation with respect to "affirmative defenses." In many of the Commission's cases, time that should be spent in determining whether a defendant has committed violations of the federal securities laws must be spent, instead, on litigation over whether the Commission's staff has, for example, complied with procedural technicalities regarding the institution of the action, provided defendants due process, and complied fully with laws that may govern Commission investigations.

The Commission has been overwhelmingly successful in cases involving assertion of affirmative defenses, but such defenses continue to be asserted and the securities bar continues to be creative in devising new affirmative defenses. If the Commission made use of Section 6103 as currently written, it is likely that the securities bar would soon find new opportunities for the assertion of affirmative defenses. The result, in my view, would be a substantial drain on already limited Commission resources.

The foregoing concerns are compounded because the statute raises the spectre of the possible criminal liability for members of the Commission staff if they make disclosures of information obtained from the IRS in violation of this highly technical law. Section 7213 of the Internal Revenue Code provides that unauthorized disclosure is a felony punishable by five years imprisonment, a $5,000 fine and dismissal from employment.

I understand that a major purpose served by the Tax Reform Act of 1976 was to assure taxpayers that information that they provided to the IRS in connection with their tax liabilities would not lightly be provided to other agencies of government. But, that policy is not applicable when dealing with information of the type sought by the Commission. Accordingly, there does not appear to be a compelling reason why the Commission should be required to duplicate an IRS investigation to obtain third-party information and other information not provided by or on behalf of a taxpayer.

In conclusion, I believe the Congress should consider amending Section 6103 to allow the Securities and Exchange Commission to obtain from the IRS information concerning a taxpayer that is not provided to the IRS by the taxpayer or a person acting on his behalf, and to use such information in all Commission proceedings to enforce the federal securities laws.

The foregoing sets forth the views of the Commission and does not necessarily represent the position of the President. We are sending a copy of this statement to the Office of Management and Budget, and will inform you of any views we receive from it on the relation of the foregoing to the program of the administration.

Chairman RANGEL. Mr. Fedders, have you made a formal request of the Service to get this extended cooperation relating to IRS information?

What is the status of the request you are making before this committee?

Mr. FEDDERS. This is the first time that this proposal has been aired publicly.

Chairman RANGEL. Well, I would suggest that you give us more details to support your request for changes in the law regarding the availability of IRS information so that the committee can have some feeling as to whether or not we should have hearings on it.

Second, without the cooperation that you are seeking with IRS, what is the track record of the Commission in enforcing existing laws with regard to those matters that come before it, or that the Commission has jurisdiction over.

Mr. FEDDERS. As I said in my testimony, investigations of fraud in connection with tax shelters is not a principal priority of the Commission. I listed those priorities that exist.

Chairman RANGEL. Have you had any cases at all?

Mr. FEDDERS. Yes, we have.

Mr. Baer might give you the exact statistics that have occurred in the recent past and I can give you the statistics with regard to the pending investigations.

Mr. BAER. In new investigations since August 1981, 13 individuals and 20 corporations have been enjoined from violations of the securities law in cases which involve tax shelters.

Mr. FEDDERS. Of the pending investigations the Commission presently has approximately 800 active investigations underway. Of those, approximately 70 involve tax shelters.

Chairman RANGEL. And of those 70, do you still believe that IRS has information which would help you with those 70 or have you received cooperation from them?

Mr. FEDDERS. The cooperation has been limited because of the provision that I referred to before.

It has come to be a one-way street. We can provide information to the Internal Revenue Service but information coming from them to us is extremely limited.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Fedders, I read part of your statement. You have registration of certain tax shelters or would you advocate that perhaps we have a system of registration for all tax shelters above a certain amount?

Mr. FEDDERS. From the Securities and Exchange Commission standpoint of view there are two possibilities. If it is a registered public offering that does not meet one of the exemptions there is a

requirement that there be registration under the Securities Act of 1933.

Recently the Commission has expanded the exemptions available for tax shelters by the promulgation of regulation D. This will afford a wider group of people, certainly larger numbers of tax shelter promoters to avail themselves of nonregistration provisions and to use the exemptions from registration.

But consistent with the philosophy of deregulation in this area, the Commission is also committed to a strong enforcement presence.

Chairman Shad and the other Commissioners in promulgating regulation D also said though there would be deregulation on the one hand, there would be strong enforcement on the other hand.

Mr. DUNCAN. How do you differentiate between those that register and those that are not required to register?

Mr. FEDDERS. Regulation D itself sets forth a substantial number of criteria as to whether or not a particular offering needs to be registered and then there is a focus on the offerees, the persons who are the purchasers, to whether they meet the criteria of investors who may be purchasers in these kinds of offerings.

Mr. DUNCAN. Would you give us some examples?

Mr. FEDDERS. I do have some of the criteria that I have brought with me. The old rules used to deem an accredited investor as anyone investing $150,000 or more. Everyone else was considered nonaccredited and fell within the 35-person limit.

Under the new rule, a person is considered accredited only if he invests at least $150,000 and his commitment does not exceed 20 percent of his net worth.

In other words, a $150,000 investor must have a $750,000 net worth to be deemed accredited. Married couples can combine their net worths to come up with a total which can include the value of homes and automobiles.

That is one of many kinds of criteria.

Mr. DUNCAN. Well, in an offering for registration, you have a certain number of people or the size or whether it is interstate or intrastate?

Mr. FEDDERS. All of those are factors. There are regulation D exemptions. There is an intrastate exemption. There are other exemptions that might be afforded to a particular tax shelter promoter who is considering whether or not there needs to be registration under the 1933 act.

Mr. DUNCAN. Is it the same for all securities registration?

Mr. FEDDERS. I didn't hear you.

Mr. DUNCAN. Is the criteria the same for all securities registration?

Mr. FEDDERS. Yes, it is.

Mr. DUNCAN. Do you think that could be tightened up some?

Mr. FEDDERS. I think what the Commission has just done in regulation D was a major step forward. This has occurred in the last several months and it is too early to determine whether there should be tightening or not.

I am a strong promoter of deregulation in this area and feel that there ought to be a strong enforcement presence with it and that is what we are trying to do in this current administration.

Mr. DUNCAN. Thank you very much.

Chairman RANGEL. Mr. Pease.

Mr. PEASE. No questions, Mr. Chairman.

Chairman RANGEL. The injunction provisions relating to fraudulent conduct, does SEC have jurisdiction to get involved in that?

It appears that what is being suggested is illegal or violative of the regulations.

Do you feel that you could take advantage of those penalty injunction provisions?

Mr. FEDDERS. If it involves the Internal Revenue's provisions——

Chairman RANGEL. No, the SEC?

Mr. FEDDERS. If it is fraud in the offer, sale, or inducement to sale of a security, the provisions of the Federal securities laws are certainly adequate for us to investigate and prosecute.

Chairman RANGEL. Well, send to the committee the request that you are making for changes in the law regarding information presently restricted by the IRS and explain why you feel there would be better enforcement of the law generally—as relates to tax shelters—if you did have this tool to work with.

Mr. FEDDERS. We would be glad to.

[The information referred to follows:]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 14, 1982.

Hon. CHARLES B. RANGEL,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR CHAIRMAN RANGEL: This is in response to your letter of November 24, 1982, in which you express interest in how the Commission responds to inquiries from tax practitioners regarding prior Commission enforcement actions against tax shelters and tax shelter promoters. You enclosed a letter from Mr. Michael E. Markovitz on the subject.

Mr. Markovitz states that he has been unable to ascertain from the Commission, the Internal Revenue Service or the Department of Justice, whether or not a person involved in a tax shelter offering has been indicted or made subject to sanctions. The Commission does, however, make such information available.

The Commission's Office of Consumer Affairs and Information Services responds to inquiries as to whether an individual or business entity has been named in an enforcement action. The telephone number of that office is (202) 272-7447.

The Commission also publishes releases concerning civil injunctive actions and administrative proceedings it authorizes. These releases are published and indexed in the weekly SEC Docket, which is available at public reference rooms at the Commission's headquarters, 450 5th St., N.W., Washington, D.C., and at the Commission's regional offices. You may wish to note for Mr. Markovitz that the address of the Commission's Philadelphia Branch Office is Room 2204, 600 Arch Street, Philadelphia, Pennsylvania. Summaries of these releases are published in the SEC News Digest, which is distributed daily to members of the press and others.

Both the SEC Docket and the SEC News Digest are available by subscription from private publishers. The Docket is reprinted by Commerce Clearing House, Inc., 4025 W. Peterson Avenue, Chicago, Illinois 60640. The News Digest is reprinted by Commerce Clearing House; by Disclosure Inc., 5161 River Road., Washington, D.C. 20016; by The Legal Times of Washington, 757 Third Ave., New York, New York 10017; and by Washington Service Bureau, 1225 Connecticut Ave., N.W., Washington, D.C. 20036.

Mr. Markovitz also states that SEC or IRS enforcement actions against tax shelter promoters should be disclosed to investors. The federal securities laws require that material information regarding an offering be disclosed whether or not it is registered with the Commission. Additionally, the Commission's rules (17 CFR 229.401 (f)) require that issuers, in registration statements pursuant to the Securities Act of 1933 and in annual reports and proxy statements filed under the Securities Exchange Act of 1934, describe certain legal proceedings or events which occurred during the past five years that are material to an evaluation of the ability or integ-

rity of any director, person nominated to become a director or executive officer of the registrant. Such legal proceedings or events include petitions in bankruptcy; criminal convictions; pending criminal proceedings; injunctions and administrative orders relating to securities and other business activities, and judicial or Commission findings of violations of federal or state securities law. A copy of this regulation is enclosed.

If Mr. Markovitz knows of instances in which information concerning enforcement actions against tax shelter promoters was not disclosed in connection with an offering, or was inadequately disclosed, we would appreciate it if he would communicate this information to us.

Your letter notes that my testimony before the Subcommittee discussed the possible modification of Section 6103 of the Internal Revenue Code, and points out that the Section was amended by the Tax Equity and Fiscal Responsibility Act of 1982 (TFRA). A legislative proposal concerning Section 6103 is being currently drafted by the Commission's staff. While the Commission has not yet considered the matter, I hope we will be able to submit such a proposal to the Subcommittee shortly.

Please do not hesitate to contact me again if I may be of further assistance.

Very truly yours,

JOHN M. FEDDERS,
Director.

Enclosure.

REGULATION S-K, ITEM 401

17 CFR 229.401(f) DIRECTORS AND EXECUTIVE OFFICERS

(f) *Involvement in certain legal proceedings.* Describe any of the following events that occurred during the past five years and that are material to an evaluation of the ability or integrity of any director, person nominated to become a director or executive officer of the registrant:

(1) A petition under the Federal bankruptcy laws or any state insolvency law was filed by or against, or a receiver, fiscal agent or similar officer was appointed by a court for the business or property of such person, or any partnership in which he was a general partner at or within two years before the time of such filing, or any corporation or business association of which he was an executive officer at or within two years before the time of such filing;

(2) Such person was convicted in a criminal proceeding or is a named subject of a pending criminal proceeding (excluding traffic violations and other minor offenses);

(3) Such person was the subject of any order, judgment, or decree, not subsequently reversed suspended or vacated, of any court of competent jurisdiction, permanently or temporarily enjoining him from, or otherwise limiting, the following activities:

(i) Acting as an investment adviser, underwriter, broker or dealer in securities, or as an affiliated person, director or employee of any investment company, bank, savings and loan association or insurance company, or engaging in or continuing any conduct or practice in connection with such activity;

(ii) Engaging in any type of business practice; or

(iii) Engaging in any activity in connection with the purchase or sale of any security or in connection with any violation of Federal or State securities laws;

(4) Such person was the subject of any order, judgment or decree, not subsequently reversed, suspended or vacated, of any Federal or State authority barring, suspending or otherwise limiting for more than 60 days the right of such person to engage in any activity described in paragraph (f)(3)(i) of this Item, or to be associated with persons engaged in any such activity; or

(5) Such person was found by a court of competent jurisdiction in a civil action or by the Commission to have violated any Federal or State securities law, and the judgment in such civil action or finding by the Commission has not been subsequently reversed, suspended, or vacated.

Instructions to Paragraph (f) of Item 401. 1. For purposes of computing the five year period referred to in this paragraph, the date of a reportable event shall be deemed the date on which the final order, judgment or decree was entered, or the date on which any rights of appeal from preliminary orders, judgments, or decrees have lapsed. With respect to bankruptcy petitions, the computation date shall be the date of filing for uncontested petitions or the date upon which approval of a contested petition became final.

2. If any event specified in this paragraph (f) has occurred and information in regard thereto is omitted on the grounds that it is not material, the registrant may furnish to the Commission, at time of filing (or at the time preliminary materials

are filed pursuant to Rule 14a-6 or 14c-5 under the Exchange Act (§§ 240.14a-6 and 240.14c-5 of this chapter), as supplemental information and not as part of the registration statement, report, or proxy or information statement, materials to which the omission relates, a description of the event and a statement of the reasons for the omission of information in regard thereto.

3. The registrant is permitted to explain any mitigating circumstances associated with events reported pursuant to this paragraph.

4. If the information called for by this paragraph (f) is being presented in a proxy or information statement no information need be given respecting any director whose term of office as a director will not continue after the meeting to which the statement relates.

[As last amended in Release No. AS-306, March 3, 1982, effective May 24, 1982, 47 F.R. 11380.]

Chairman RANGEL. Now we will hear from Mr. Jerome Kurtz, former Commissioner of the Internal Revenue Service and chairman of the ABA Tax Shelter Study Special Committee.

We want to thank you for continuing to give your support and cooperation to public matters that affect taxpayers even though you are in the private sector.

STATEMENT OF JEROME KURTZ, CHAIRMAN, TAX SHELTER COMMITTEE, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION (FORMER COMMISSIONER OF INTERNAL REVENUE)

Mr. KURTZ. Thank you, Mr. Chairman, Mr. Duncan.

I have a statement which I would appreciate having inserted in the record in full. I will just summarize a few points from it.

Chairman RANGEL. Without objection.

Mr. KURTZ. Let me say first that recent legislation, the Economic Recovery Tax Act last year and TEFRA this year, have provided the Service with a range of very important tools to deal with abusive tax shelters. The new penalty for overvaluations increases in the interest computation and negligence penalties, the new promoters penalty, the so-called no-fault penalty, and the partnership audit proposal. While all of these provide very important tools to the Service, they will work in the long run only if the Service has the resources to identify and move cases and impose the penalties where appropriate. Otherwise, they will simply become paper tigers.

In recent years the resources of the Service have been grossly inadequate. The Service has done a first-rate job in identifying abusive shelter returns and in processing them. But when the Commissioner testifies that there are 300,000 cases pending, and when I was there there were 200,000 cases pending, there is something wrong with tax administration and what is wrong is the absence of adequate resources to move these cases. Inadequate resources has been a problem for a long time and it is a problem that has been exacerbated in recent years.

I might say the current administration's budget proposals which, on their face, seem to add 5,000 positions to the Internal Revenue Service, do little more than make up for previous cuts.

The overall staffing of the Internal Revenue Service under existing budget proposals for 1983 will not bring it back to the staffing that it had in 1981, which was grossly inadequate also.

So I would say that to deal effectively with this problem in the tax system the most important thing that can be done is to provide

the Service with reasonable amounts of resources. Obviously those resources pay for themselves.

We have a goose out there that is laying a $600 billion a year golden egg and we are unwilling to spend 50 cents per hundred dollars to care for the goose which seems to me a serious misallocation of resources.

Another point I would like to make is that our Tax Code is replete with provisions generally referred to as tax expenditures, the purpose of which is to encourage or reward certain kinds of economic conduct. Every time Congress creates a tax expenditure or permits one to remain in the code, Congress creates a tax shelter. After all, that is what a tax expenditure is. And then the question becomes whether that provision becomes abused or whether it is doing what Congress intends it to be doing. But abusive tax shelters are all based on some underlying tax expenditure, whether it is the deduction for intangible drilling costs or accelerated depreciation or the investment credit or one thing or another.

And it is through attempts to magnify the availability of those benefits that we get abusive shelters.

Chairman RANGEL. How do we here in Congress control the conduct of the investor? How can we be certain that the investor hopes to make money?

How do you distinguish between those type of cases where the investor hopes that he can make a dollar and the tax expenditure provision is an incentive because it would lessen his tax liability from those cases where the investor is not looking to make money, the investor just wants to shelter income?

Mr. KURTZ. Well, there are various definitions of abusive tax shelters. As was suggested earlier, a good test, putting aside only the real estate area where Congress has acted specifically to exempt it from the at-risk rules, generally speaking, is that if an investor can look to a tax advantage such that the economic return becomes unimportant, there is an abuse in there somewhere.

With the widespread application of at-risk rules it is very difficult, if not impossible, under existing law to magnify tax deductions beyond the dollars invested.

There may be narrow gaps in the statute which may be big enough to let a taxpayer through or there may not be. There are still cases to be litigated.

But I would suggest this, if I may, Mr. Chairman: In this committee's continuing role in oversight, I think it worthwhile looking on a continuing basis at how tax expenditures in the code are working. That is, are they being used only by those taxpayers and only to the extent that Congress intended or are they being magnified out of proportion to what Congress intended, legally or illegally?

That is, if they are being exploited in a way that may fit within the statute technically but is not what Congress intended, then the crack in the statute should be promptly closed. There should be a continuing forum to whom the Service may present apparent problems as it discovers them.

Even if the Service believes that the taxpayers' exploitation of the particular provision is beyond the scope of the law, it will take years until there are definitive court decisions closing the loophole. In the meantime, it will be exploited. The legislative process ideally

can work much faster than the judicial process in clarifying what may amount to certain ambiguities in the statute.

I think the Service or this committee's staff ought to undertake research projects to see how the tax law is working. One that you suggested, which is very appealing, might be to put together a list of very wealthy people in the United States and do research and see whether those people are paying what Congress believes is a fair amount of tax.

This is not for publicity or to target particular people but as a research project to see how the tax laws are working as applied in individual cases.

One other point I would like to make relates to Mr. Fedders statement concerning 6103. That has been a longstanding interest of mine also.

Whether there is a problem with 6103 in the SEC's inability to get information I think remains to be seen. The SEC has not asked for information, as I understand it, and according to Mr. Fedders' statement. There are provisions of 6103 which make information readily available to other agencies in a variety of circumstances but subject to protection—court orders or requests or whatever.

I think those protections are needed and I would suggest that before there is an attempt to change legislation, the SEC sit down with the IRS and see if procedures can be worked out within the existing provisions of 6103 to take care of the perceived problems.

I have no doubt that the present provisions of the schedule can be made to work efficiently if both sides enter into those discussions with goodwill and at the same time legitimate privacy interests will be protected.

Mr. Chairman, those are the particular points I wanted to make. I don't want to repeat what others have said this morning. If there are any questions I would be happy to answer them.

[The prepared statement follows:]

STATEMENT OF JEROME KURTZ

Mr. Chairman and Members of the Subcommittee, my name is Jerome Kurtz. I am a practicing attorney in Washington, D.C. From 1977 to late 1980, I was Commissioner of Internal Revenue. While in that position I devoted a great deal of time and energy to the problem of abusive shelters because I believed that curtailing the use of these schemes was critically important to the long term health of our self-assessment tax system. My interest in the problem continues and I now serve as Chairman of the Tax Shelter Committee of the American Bar Association's Tax Section. My comments today are in my individual capacity.

Dealing with the widespread use of abusive tax shelters is a very difficult task, and while we can take considerable satisfaction from what has been accomplished, the job is not finished. I therefore commend this Subcommittee for addressing this problem and appreciate your invitation to participate with you in these hearings.

A tax shelter is a type of investment or a transaction which produces tax deductions in excess of real economic loss—and usually in excess of any otherwise taxable income produced in the transaction. The investment usually produces net losses which offset unrelated income, thus "sheltering" such income from income taxes which would otherwise be due. Certain tax sheltering activities are clearly sanctioned by the tax laws; real estate is an example. Because depreciation deductions for real estates usually exceed by a substantial amount any real decline in value of the asset, investors in rental real estate frequently have tax losses where they have real cash flow as well as economic income. Whenever Congress decides to subsidize a particular type of investment through the tax system, it creates a potential tax shelter.

An abusive tax shelter, however, is one which Congress has not sanctioned. An abusive shelter may be defined as a transaction which a taxpayer enters for the primary purpose of gaining a reporting position for claiming a deduction or credit on his tax return which, while not allowable, may produce significant savings either because his return will not be examined or, if it is examined and the claimed deductions are disallowed, the advantage of low cost deferral will be achieved. If the shelter is one where the claimed benefits are, in fact, allowable under the law, the shelter is not abusive although the scheme may not be a desirable one from a tax policy point of view.

The marketing of tax shelters has become a very substantial activity, particularly over the last ten years or so. In the early days the laws were very generous and many of the tax shelters were permitted under the Code as it then existed but clearly evidenced undesirable policy. Many provisions lent themselves to exploitation and abuse. As these situations became known to the Administration and Congress, legislation was enacted designed to eliminate what were considered to be the undesirable activities. Substantively this has been accomplished by the introduction of "at risk" rules, first applied only to certain specific activities and partnerships and later expanded to cover all investments, excepting only real estate. The purpose of these rules was to prevent the exploitation of tax incentives by unrealistic leveraging. Under these rules a taxpayer's total deductions are limited to the amount he has actually invested or is personally at risk for.

As the law on tax shelter activity has become tighter, promoters have moved farther and farther to the fringes of the law, and frequently well beyond the fringes, in promoting deals which they claim are not clearly covered by the restrictions.

It became apparent by the middle 1970's that tax shelter activities were undermining taxpayer confidence in the fairness of our tax system. There were widespread reports of high income taxpayers paying little or no tax by engaging in what were essentially economically artificial transactions designed primarily to reduce current taxes. As the Service began to address this problem, it became clear that better means were needed to identify for examination those returns containing substantial deductions from tax shelters. This was accomplished in several ways.

Prior to 1978 all returns were classified on the basis of adjusted gross income, which is the amount left after netting income and deductions. Thus, a taxpayer with $200,000 of salary, interest and dividends and $190,000 of losses from tax shelters would file a return with $10,000 adjusted gross income. The percentage of returns examined by the Internal Revenue Service varies with the income class of the return. Obviously, the lowest income returns have the smallest examination coverage. Therefore, the taxpayer just described would fall into a class where the percentage of returns examined was less than one-half of 1 percent.

Moreover, the Internal Revenue Service traditionally had no separate examination program for partnership returns. Partnerships were generally examined only in connection with the examination of a partner at the discretion of the examining agent where it appeared that a substantial amount of the partner's income was attributable to the partnership. Tax shelters were usually partnerships with many partners and while large amounts of revenue could be involved in each partnership, the impact on the return of an individual partner was not usually sufficient to warrant an examining agent's deciding to examine the partnership.

Two major procedural reforms were made during 1977, 1978 and 1979 to change this situation. First, a separate partnership audit program was initiated and a very high percentage of partnership returns showing significant losses were examined. Second, the entire classification system of tax returns was changed so that returns are now classified on the basis of total positive income, i.e., the sum of all income without offsets for losses. As a result of these changes, I believe the Service is now identifying most tax shelters. Indeed, the problem it now faces is how to deal with the enormous number of abusive shelters it has uncovered. The number of cases in the various stages of the examination and appeals process involving abusive shelters is in the hundreds of thousands and the number of unresolved cases going to the Tax Court is seriously straining the ability of the Court to deal with its caseload. Detection, examination and disallowance, of course, are essential in handling these abuses to the tax system. But unless the Service is allowed substantial additional resources, the problem borders on unmanageability. It is, therefore, essential to address some of the root problems so as to discourage taxpayers from engaging in these activities.

In June of 1981 I published a short article entitled "Notes to a New Commissioner of Internal Revenue" [1] in which I discussed this problem. I would like to quote some of what I said there.

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[1] Tax Notes, Volume XII, Number 22, pg. 1196-1197, June 1, 1981.

". . . The Service has had a very active program on tax shelters for the past four years. Numerous rulings have been promptly published in an attempt to be responsive to new schemes. Substantial examination resources have been directed to shelter returns, both partnership and individual. These efforts have shown that the problem is one of major proportions which has a seriously demoralizing effect on our tax system. The Service has over 200,000 returns involving abusive tax shelters at various stages of the examination process in addition to those that have been closed or are in internal appeals or the courts.

"These returns involve over $5 billion in deductions and hundreds of millions of dollars of investment credit. The tax revenues involved are probably in excess of $2.5 billion. If so many taxpayers are claiming so much in tax benefits that seem clearly beyond the law, then something is wrong with our tax system. Getting to the root of the problem should be a matter of high priority.

"I strongly recommend that my successor continue the vigorous pursuit of abusive tax shelter schemes. This is not easy to do and will require constant attention and a firm commitment. The resource demands of this program are substantial and are particularly difficult to meet in times of tight budgets. The administrative problems are enormous—keeping track of various schemes and coordinating the work on related cases, moving cases through the examination and appeals functions in some coordinated and consistent way when the taxpayers involved are all over the country, identifying returns and securing necessary consents to extend the statute of limitations while examination activity proceeds on related cases, and moving perhaps tens of thousands of cases into the Tax Court where the court will be faced with the formidable burden of consolidating cases and managing dockets.

". . . Intense enforcement activity alone will not, however, eliminate the problem of abusive tax shelters. Fundamental changes to the law are essential. Substantive amendments to the Code to eliminate the structural elements of various schemes should, of course, be pursued. For example, legislation is needed to deal effectively with abuses involving certain commodity and financial future transactions. The fact that the government may eventually prevail in litigation will still not prevent many taxpayers from engaging in such transactions and taking aggressive reporting positions on their returns.

"But I believe a more fundamental change is needed—a change that would affect the willingness of taxpayers to take highly doubtful positions on tax returns. The major attraction of many tax shelter schemes is based on the taxpayer's belief that participation in the scheme will afford the opportunity to file a tax return showing less taxable income than he believes he really has but with little or no penalty for being caught. He believes that, at worst, his deductions or credits will be disallowed, so that while eventually he will have to pay the tax, the payment lies in the future and then only with interest at a bargain rate. Thus, even the loss of his tax case and his investment is still probably a fair price to have paid for the deferral of tax at low interest rates. This is the extent of the risk. But the benefit is that he may not be audited at all, in which event he has reduced or substantially deferred his taxes improperly. A tax shelter may be thought of as a free or almost free ticket to the audit lottery.

"An abusive tax shelter, at its worst, may be defined as a scheme designed to give a taxpayer a reporting position for claiming a deduction or credit in the hope that his return will not be examined or that tax can be deferred without penalty.

"There are many ways taxpayers can play the audit lottery, but most are far riskier than investing in tax shelters. There are a few taxpayers who do not pay taxes on the grounds that the income tax is unconstitutional, or that federal reserve notes are not legal tender and therefore not income. Some set up so-called family trusts or offshore double trusts to which they purport to assign their income. Some claim that they are exempt from tax as ministers on the basis of mail order ordinations. There are others who simply omit income or fabricate deductions or exemptions. These ploys, however, are risky indeed. Taxpayers who engage in these practices are regularly convicted of tax fraud and sent to jail or subjected to civil penalties.

"The difference between these tactics and many of the abusive shelters is simply that the investor in a shelter is rarely penalized.

". . . Abusive tax shelters are the progency of the present standards set for reporting transactions on returns. If taxpayers claiming such tax shelter deductions or credits—with or without opinions [of counsel]—did so at the risk of significant penalties if the claim were ultimately determined to be wrong, abusive shelters would diminish substantially.

"At one time I suggested that taxpayers be required to highlight certain questionable deductions or credits on their tax returns. Such a requirement would almost certainly make investments in abusive shelters less attractive because the odds on

the audit lottery would be considerably shortened. But no shortening of the odds will stop taxpayers from playing the game as long as the ticket to play is free—as long as there is little or nothing to lose.

"The more I have thought about the problem, the more convinced I have become that the basic problem lies in our penalty structure. We now have penalties only for fraud or negligence in reporting. Courts seem generally unwilling to apply these penalties to taxpayers in tax shelter transactions involving professional opinions even where the opinion is highly qualified. Moreover, the negligence penalty is only five percent—hardly a deterrent and not enough to result in any real risk of loss.

"I believe that if our self-assessing system is to continue to work it should provide a financial penalty which would discourage taxpayers from playing the audit lottery. Such a penalty might be limited to substantial deficiencies arising out of transactions or investments which had a significant tax-avoidance motive. In this form it would deal directly with the tax shelter problem. Alternatively, a penalty might attach to all substantial deficiencies, in which case it would deal with the broader problem of overall standards of reporting. There could be provisions to mitigate such a penalty upon a showing that the position taken, while determined to be wrong, was reasonable. The penalty could be a stated percentage of the amount of the deficiency or could be determined by applying realistic interest rates and then denying deduction of the interest in these situations. In the latter case, the result would be a heavier penalty for higher income taxpayers.

"Work would have to be done to determine the appropriate type and level of deficiency to which such a penalty would attach and the amount of the penalty. Routine errors on returns and the returns of average taxpayers are clearly outside the target.

"A strengthened penalty structure would deal directly with the root of the abusive tax shelter problem. The taxpayer would then have the burden of evaluating the real risk that the claimed tax benefit might be disallowed with the attendant penalty. I am convinced that the opinions of professionals would become much more precise in appraising the tax shelters and the risks and that taxpayers would be more inclined to read those opinions. The opinions would be given more carefully because the professionals would recognize the risk of claims against them by taxpayers who relied on their opinion but were penalized when the opinion proved to be wrong.

"Many of us as practitioners have had a client ask our views on some shabby tax shelter scheme that he had been offered, but after concluding that the deductions offered were very likely not allowable, were forced to tell the client that he had nothing to lose by investing.

"This situation is demoralizing to thoughtful tax practitioners just as the widespread use of abusive tax shelters is demoralizing to the tax system. The system cannot operate by offering unjustified rewards to high income taxpayers without the offsetting risks. An appropriate penalty structure of the type described would relieve much of the pressure on the system and on practitioners.

". . . A more rational penalty structure would thus be one that discouraged taxpayers from playing the audit lottery by requiring both taxpayers and their advisers to address the probable allowability of tax benefits, rather than simply whether the position taken will not attract a negligence or fraud penalty. Achieving this goal would do much to assure that high income taxpayers meet their fair share of the tax burden and consequently would do much to increase the confidence of the average taxpayer in the fairness of the system. It is a goal that must be pursued."

Much of what I had hoped for at that time has been accomplished. The Economic Recovery Tax Act of 1981 (ERTA) dealt comprehensively with the problem of commodity straddles. It also contained a specific penalty on deficiencies due to substantial overvaluation of assets, a problem at the heart of many abusive shelter schemes, and increased the negligence penalty.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) contains several new penalties directed to the tax shelter problem: penalties and injunctive relief against promoters of shelters who make false or fraudulent statements about tax consequences; more current and realistic interest rates on deficiencies; and a special 10 percent penalty on substantial deficiencies attributable to abusive shelters.

TEFRA also contains new rules governing partnership audits and litigation, first proposed in 1978. These provisions will be a substantial help in managing the examinations, appeals and litigation involving partnership tax items.

Whether these provisions will have their intended effect, of course, remains to be seen. I would hope that this Subcommittee will, in the exercise of its oversight jurisdiction, review on a continuing basis how well this legislation is working.

It is, moreover, important to monitor the broader question of whether existing tax expenditure provisions of the Code are being utilized as they were intended or whether they are being expanded beyond such Congressional intent and exploited as tax shelters. In this regard, I believe it would be extremely useful for this Subcommittee, in the exercise of its oversight jurisdiction, to provide a forum where the Internal Revenue Service could, on a continuing basis, present to this Subcommittee information which it has obtained indicating situations where it appears that taxpayers are claiming advantages under the Code which push beyond Congressional intent and to present proposals to rectify such unjustified extensions. In order to obtain this information, I believe the Service should, on a continuing basis, review selected returns of wealthy taxpayers who appear to be paying proportionately small amounts of tax to determine those provisions of the law which are responsible for such tax reductions and to present its findings to this Subcommittee so that corrective legislation may be considered.

As long as Congress uses the Internal Revenue Code to promote economic activity through tax expenditures, the potential for abusive shelters exists and requires constant monitoring if the integrity of our tax system is to be preserved.

I will be pleased to try to answer any questions the Committee may have.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. I have no questions.

Chairman RANGEL. You were saying that you have no reason to believe that there is any targeting in the IRS to review and audit partnerships.

I think that was in your written testimony.

Mr. KURTZ. No; I said that early on there was no separate audit program for partnerships. By that I mean the Internal Revenue Service has a certain budget for examining tax returns and then that budget is allocated to returns of various types—corporate returns of a certain size, et cetera.

There was historically no separate audit program for partnerships whatsoever. That has been changed. There is now a separate audit program where partnership returns are selected.

Prior to 1978 or so, partnership returns were only examined when a Revenue agent examined an individual return and that return had substantial income from a partnership, then the Revenue agent would go to examine the partnership.

That is one of the reasons why the Service was rather slow in getting into the tax shelter area.

When that was changed to have a separate allocation of resources to examine partnerships, the number of tax shelter cases just skyrocketed.

Chairman RANGEL. Did you have the same problems in requesting additional resources when you were Commissioner dealing with OMB?

Mr. KURTZ. OMB has been a problem to almost everyone who has ever wanted money in this Government, I think.

Chairman RANGEL. But you used a classic example of return on investment when we were talking about not being able to audit enough returns.

I think you can prove statistically that you can get more than $1 return on every $1 of investment in the IRS. I can understand problems that other agencies and departments would have with OMB but I can't understand it with IRS since you have this return for each investment——

Mr. KURTZ. There are statistics which are uncontrovertible—not even controverted by OMB, I might say, even as they turn down the request. The IRS with additional resources of very, very signifi-

cant amounts can continue to produce $6 or $7 per $1 spent even if the additional resources are spread in a balanced way.

That is, such resources are not all devoted to enforcement. Resources devoted to the collection area, for example, produce $15 to $20 per $1. This has been going on for years and years and years, so that the statistics are not subject to question; $5 or $6 per $1 would represent an absolute minimum return on additional resources to the Service and I might say that return would continue.

At some point obviously it would fall off but we are not within shouting distance of that amount.

Chairman RANGEL. And you can't even give an estimate of the confidence in the system which strict enforcement would produce. More people might think that it makes a lot more sense to pay the taxes which we are now losing every day.

Mr. KURTZ. That, of course, is the other side of it. The Service has the capacity, that is the technical capacity, but not the resources, to identify tax shelter returns immediately upon filing and could commence audits within 30 days of the time such a return is filed. My guess is that if the Service had the resources and did that on a continuing basis and then had the resources to move these returns through the system promptly and taxpayers generally understood that if they filed a return with an abusive shelter loss they would get a notice of examination in 30 days this problem would dry up. The technical capacity is there. It is easy to do but there are no resources to do it.

Chairman RANGEL. What is the function of the tax shelter study committee of which you are the chairman.

Mr. KURTZ. Well, it is a committee of the tax section of the American Bar Association.

I might say I am not representing that committee in this hearing. I am appearing on my own. That committee is concerned with all aspects of tax shelters.

Chairman RANGEL. Would the bar association disagree with anything that you have said?

Mr. KURTZ. I would hope not but I haven't tried the procedure for gaining approval. There was not time.

Chairman RANGEL. What is the function of this committee that you chair, though?

Mr. KURTZ. The committee is concerned with the problems to the tax system presented by tax shelters. It is divided into four subcommittees which defines its function as well as any.

There is a subcommittee that deals with penalties. There is a subcommittee that deals with internal procedures at the Internal Revenue Service. There is one that deals with substantive matters, and another deals with standards of practice.

Chairman RANGEL. It would seem to me that it would make a lot of sense for the bar association to do this because some of us who are not practicing law believe that the only way we can avoid abuse is to try to get people indicted. The abuses give the profession a bad name and there should be a way in which lawyers and accountants would want to make their contribution to good government.

What I am suggesting is that while you have always been very helpful to us, it would be of some help to this committee if the bar

association could analyze their role in providing advice on tax shelters and make recommendations to the Congress as to how we could improve the law to avoid abuses. The tax shelter promoter is the one that is taking how the heat and the investor is protected.

Mr. KURTZ. Mr. Chairman, the committee has been quite active and has been dealing primarily with the Internal Revenue Service and not directly with the Congress.

The committee has been dealing with senior officials at the Service for several years with that goal.

Chairman RANGEL. Well, I am talking about image and perceptions as one lawyer to the other. If, in fact, you are making this type of contribution the bar association would not want the abuses to appear to be all-encompassing.

Mr. KURTZ. I think that is clearly correct.

Chairman RANGEL. And they, too, are working to cut out the abuses so that when people think of lawyers they don't automatically think of someone involved in wrongdoing.

Mr. KURTZ. When we talk about abusive shelters that amount to criminal conduct, we are talking about a very, very small element of the bar and accounting profession that would participate in that kind of conduct.

Chairman RANGEL. I do not make myself clear, I guess.

I am not talking about those shelters that are criminal. It would be criminal if lawyers did not speak out against criminal activities. However, when it comes to sound tax policies, and where the question is putting members of the bar in jeopardy as to whether or not they cross the criminal or abusive line, it would seem to me that the bar association should make some sound, well-thought-out recommendations to the Congress based on their experience, and, in fact, they may be placing themselves in jeopardy with a law that is not that clear.

I recognize you did not testify today in your capacity as chairman of the shelter committee. I am asking that the bar association, and I will ask staff to reach out to the accountants and the CPA's, and ask that they, too, make recommendations. So, when we start reacting, we don't overreact and ask that the grand jury take care of every problem the Congress failed to be specific in.

Mr. KURTZ. We would be pleased to cooperate in any way that we can, Mr. Chairman.

Chairman RANGEL. Mr. Shannon.

Mr. SHANNON. I have no questions.

Chairman RANGEL. Let me thank you again for your past cooperation with this committee, and if you have other recommendations, we do not need to go through the formal route to get them to the Members of Congress, just contact our staff.

Mr. KURTZ. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Aidinoff, chairman, Section of Taxation, American Bar Association.

STATEMENT OF M. BERNARD AIDINOFF, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. AIDINOFF. Good morning, Mr. Chairman.

Chairman RANGEL. Do you two work together?

Mr. AIDINOFF. On many things, Mr. Chairman. I was fortunate to be a member of Commissioner Kurtz' advisory committee, when he was Commissioner.

Chairman RANGEL. Thank you for testifying in front of the committee. We have your testimony, and you may testify as you may desire.

Mr. AIDINOFF. I would appreciate it if you would include my entire statement in the record.

I will try to shorten my remarks somewhat.

Chairman RANGEL. Without objection.

Mr. AIDINOFF. I am the chairman of the Section of Taxation of the ABA. The views that I will express are my own personal views.

I hope, however, that most of my fellow tax practitioners will be in agreement with them.

Let me say, Mr. Chairman, that the Section of Taxation of the ABA has worked very closely with the staff of the House Ways and Means Committee, the Joint Committee, and the Senate Finance Committee on many tax shelter proposals, and many of the penalty provisions that were added by the recent legislation were the result of discussions with the tax section.

Chairman RANGEL. Well, has the ABA put out in any of its publications directions for attorneys as to how professionally they should conduct themselves when advising clients as to whether to get involved in a tax shelter?

Mr. AIDINOFF. The Standing Committee on Ethics and Professional Responsibility of the American Bar Association has issued opinion 346, which sets forth the ethical considerations which lawyers are supposed to follow in issuing tax shelter opinions.

Chairman RANGEL. What are roughly those considerations?

Mr. AIDINOFF. Basically, those ethical considerations are, one, you have to opine on a real transaction, not on the basis of hypothetical facts.

Two, you obviously have to avoid giving a false opinion.

Now, I would say that the most important ethical guidelines that are there are that the opinion must address all the material tax consequences of the investment, or you must make sure that somebody else has properly addressed all of those material tax aspects.

In other words, it is improper to just opine on one aspect of a tax shelter, leaving the investor without knowledge of the other material aspects of the shelter.

In the past, it was quite common for lawyers to restrict their opinions to a partnership being a good partnership for tax purposes and not commenting on other tax aspects like the availability of the depreciation deductions.

The most important aspect of opinion 346 is the requirement that in giving a tax shelter opinion, one must give an overall evaluation as to whether the significant tax benefits contemplated by the tax shelter will be realized or not, or that the probability of realization and nonrealization are evenly divided.

That basically means, you have got to call the bottom line on a tax shelter, and, for this purpose, the opinion defines a tax shelter as any type of investment in which the deductions in any year exceed the income in any year, or alternatively when one is talking

about an investment tax credit, where the amount of the credit exceeds the tax on the income from the investment.

Chairman RANGEL. From the testimony, it appears that the most valuable service that a lawyer could render to a client is the opinion that would remove the question of criminal intent from the investor.

Mr. AIDINOFF. If we have compliance with the standards of opinion 346, and the investor reads the opinion, we should have a situation in which if the opinion is favorable, or evenly divided, and there is an investment, obviously that would preclude criminal intent.

If the opinion is negative, then it seems to me it would be very difficult to rely on the opinion in order to use it as a defense against criminal or fraudulent or negligent conduct.

It may be that we will sometimes have the type of opinion which indicates that while the opinion is negative, there are substantial arguments in support of a position. In that particular case it would be very hard to say that there was negligence, fraud, or criminal intent. But if you have compliance with opinion 346, you are not going to have the type of situation where the opinion that is given is a so-called reasonable basis opinion and the reasonable basis is some very slim reed; in other words, an imaginative lawyer has come up with an offbeat argument, and nothing more.

In my judgment, if all a lawyer gives is a reasonable basis opinion, that, by itself, does not give protection against fraud or negligence.

If a lawyer gives an opinion that is favorable to a particular investment, and the opinion is wrong, that gives protection to an investor, but if all he gives is a reasonable basis opinion, that in itself does not give insurance against a fraud or negligence penalty, except if, in fact, there is a reasonable basis.

Chairman RANGEL. I did not understand that to be part of the law.

If someone relies on a lawyer, and a lawyer gives a reasonable basis opinion, they don't have to go beyond that in order to be protected against criminal intent, even if there is no reasonable basis.

Reasonable basis for a lawyer should be a much higher standard than for the investor.

Mr. AIDINOFF. Sir, I agree with you with respect to something that requires criminal intent.

Chairman RANGEL. That is all I meant.

Mr. AIDINOFF. I would disagree if you extended those comments to civil fraud or negligence.

At any rate, I think we have now reached the point where, because of the new penalty provisions that have been added in TEFRA, particularly with respect to understatement of tax liability—where the standard now in order to avoid the penalty is substantial authority, and in the case of what you would call an abusive tax shelter, it is more likely than not that the particular deduction will be allowed—the use of reasonable basis opinions will disappear.

Chairman RANGEL. If there are any publications put out by the bar association in connection with abusive tax shelters, I wish you would send them to me.

Mr. AIDINOFF. I shall, sir.

I believe strongly that some of the new penalties and injunctive provisions added by TEFRA should substantially eliminate many of the abusive tax shelters.

I might also add that as long as we have high tax rates, you are going to have some people who are going to be looking at schemes which no responsible lawyer would approve.

The big hope is that through the use of the new penalty provisions, you might cause a responsible portion of the taxpaying public not to invest in tax shelters.

Insofar as the 400 who were mentioned in Forbes, I suspect to the extent they have reduced their taxes, they have done so through investment in real estate, investment in oil with the intangible drilling deductions allowable, and the good fortune to have developed a business which subsequently took off, and which they were able to dispose of at capital gains rates.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF M. BERNARD AIDINOFF

Congressman Rangel, members of the Subcommittee on Oversight, thank you for inviting me to testify this morning. My name is M. Bernard Aidinoff. I am the Chairman of the Section of Taxation of the American Bar Association. The views that I will express are my own personal views. I hope that many of my fellow tax practitioners will be in agreement with them.

As pointed out in your notice of hearing, both abusive and legitimate tax shelters achieve their goals of reducing tax liability by (1) leverage which permits the claiming of tax losses through the increased depreciation and amortization deductions available with respect to assets purchased with borrowed funds, including funds for which there may be no personal liability; (2) conversion of ordinary income into capital gain or of short-term capital gain into long-term gain; (3) the use of accelerated depreciation and current expensing to defer tax liability. The opportunities for the use of these techniques in legitimate tax shelters have been substantially reduced in recent years with the inclusion in the tax laws of at risk concepts and the modification of other substantive areas—for example, the treatment of interest during construction. To the extent these techniques can still be used in legitimate tax shelters this is the result of conscious Congressional action approving and encouraging this type of investment—for example, the current deductibility of intangible drilling costs and the exclusion of real estate from the at risk rules.

While abusive tax shelters may use some of the same techniques as legitimate shelters, they tend to have other characteristics. Your notice refers to back-dating documents, assuming the existence of nonexistent assets and using foreign corporations or foreign bank accounts to camouflage the nature of the transactions and hiding the identities of the parties. In most of these instances, we are dealing with criminal conduct. We do not have a tax shelter at all, but an outright evasion of taxes, no different from the claiming of nonexistent deductions or failing to report income. These are situations that can only be handled by vigorous enforcement of our criminal tax laws and the assertion of civil fraud penalties, with adequate publicity being given to prosecutions in this area. Of course, how much can be done in this area is dependent upon the Internal Revenue Service having the machinery and resources to find the illegal conduct and the ability of the Justice Department to prosecute these cases. These abilities are very much dependent on our enforcement agencies having the necessary financial resources.

Your notice also refers to two other techniques used in abusive tax shelters: (1) claiming deductions for debts not actually at risk, (2) inflating the value of assets. Obviously, if there is outright evasion of the at risk rules, we are dealing with criminal conduct. However, there may be instances where legitimate questions may be raised as to whether the investor is at risk and, more particularly, the time at which he is at risk. It is, of course, important that the legitimacy of the at risk investment be examined in order to discourage investors from treating as at risk those liabilities that are not.

Inflating the value of assets may raise the amount of deductions available with respect to investments which are financed with non-recourse purchase money debt in areas that are not subject to the at risk rules. To the extent that property is subject to non-recourse purchase money debt, additional basis for depreciation is obtained only if the debt does not exceed the fair market value of the property. Even with investments subject to the at risk rules, an inflated value of the asset may accelerate the deduction of that portion of the investment that is at risk.

Over-valuation has also resulted in abusive tax shelter in the charitable area. I am afraid that the steady inflation of fair market value on charitable gifts of real and personal property has been too common. It is part of many taxpayers' normal game playing. Here again, they only remedy is constant vigilance and appropriate Justice Department action in select cases. In the Economic Recovery Tax Act of 1981, a new penalty was added with respect to overvaluation. It was a penalty endorsed by tax administrators and many members of the tax bar. There has not been sufficient time to test the effect of this penalty, but in my opinion, it should be a useful tool in handling gross overvaluation cases. Hopefully, the existence of the penalty will itself reduce substantial overvaluation.

I do not really know whether the number of abusive tax shelters has increased or not. Taxpayers, particularly those in the top bracket, are still interested in reducing their tax liabilities. On the other hand, many taxpayers have as a result of past investments in tax shelters realized that some of them do not make economic sense and that the tax advantages promised have not in fact materialized. Many taxpayers have been subject to recapture liabilities as a result of the foreclosure of transactions that were badly structured from an economic point of view. Other tax shelters are maturing and taxpayers are becoming cognizant of the substantial tax liabilities that may be payable at the time of sale or during the period when there is no more available depreciation and cash flow is committed entirely to the payment of debt.

I still receive in the mail advertisements and offering circulars for tax shelters. Many are legitimate transactions; other are almost laughable. During Commissioner Kurtz' administration, he instituted the practice of publishing rulings covering new types of tax shelter transactions that had serious defects. In my judgment, prompt publication has the effect of discouraging investments in many of these tax shelters by taxpayers who do not want to be involved in questionable transactions—although it carries with it the risk of publicizing such shelters and causing cynical taxpayers to invest.

Congress recently enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which contains numerous new penalty provisions affecting not only taxpayers, but promoters of tax shelters and advisers. The new penalty with respect to substantial understatement of tax liabilities should discourage investment in borderline shelters. It should also encourage the disclosure of aggressive tax positions by taxpayers in shelters with legitimate economic objectives. The authority to seek injunctions against promoters of abusive tax shelters should also be useful. The partnership audit provisions should considerably aid the Internal Revenue Service in handling tax shelter cases. The advantages of the interest play previously available with respect to faulty tax shelters has been eliminated through the new interest compounding provisions and through additional penalties. These are desirable new provisions. In my opinion, this is not the time for further legislation but a time to utilize these new tools and see whether they work. Hopefully, they will reduce the attractiveness of borderline tax shelters.

Your invitation to testify referred to the use of reasonable basis opinions in connection with tax shelters. By reasonable basis opinions, I mean opinions in which the professional giving the advice could not give a favorable opinion with respect to the tax aspects of a transaction, but could state that arguments could be made in support of a position favorable to the investor. In many instances, reasonable basis opinions may have been given when the only support for the position was a slim reed and where there was no substantial authority supporting the position. Reasonable basis opinions were sometimes regarded as insurance against fraud or negligence penalties. In fact, a reasonable basis opinion would provide such protection only if the authorities (or lack of authority) provided a reasonable basis for the position. Reliance on a professional's opinion may give protection against fraud or negligence when the opinion is in fact favorable to the taxpayer's position (whether or not the opinion is correct). A reasonable basis opinion by itself does not give such protection.

Opinion 346 of the Standing Committee on Ethics and Professional Responsibility of the American Bar Association sets forth the standards and ethical considerations which should be applicable to opinions by lawyers analyzing the tax effects of an investment in a tax shelter offering. To comply with the opinion's ethical guidelines

a lawyer rendering a tax shelter opinion must opine on all material tax issues and, in addition, give an over-all evaluation as to whether the significant tax benefits contemplated by the tax shelter will be realized or not, or that the probability of realization and non-realization are evenly divided. ABA Opinion 346 effectively precludes the use of reasonable basis opinions by responsible lawyers.

Furthermore, the new penalty provisions in TEFRA with respect to substantial understatement of tax liability should eliminate the abuses caused by reasonable basis opinions. In fact, it should eliminate entirely the use of reasonable basis opinions in the tax area. Under new Code section 6661, the penalty is reduced by that portion of the understatement attributable to the tax treatment of an item by the taxpayer for which there is or was substantial authority for such tax treatment. In the case of a tax shelter, as defined in the section, the penalty can be avoided only if "the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment".

Responsible members of the tax bar have the same interest as the members of this Subcommittee in curbing the use of abusive tax shelters. Our tax system can only work if the public has respect for it. The enactment by the Congress of the new compliance and penalty provisions in TEFRA and the utilization of these provisions by the Internal Revenue Service and the Department of Justice should aid considerably in achieving this objective.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. No questions.

Chairman RANGEL. Mr. Shannon.

Mr. SHANNON. One question.

One of the things that lawyers do is advise clients that they have a reasonable chance of realizing the tax benefit because of the low rate of audits, in effect, if we were only auditing 2 percent of these cases. Doesn't that give lawyers reason to advise clients that, well, the chances of your realizing a tax benefit are very, very great because the odds of your being audited are very, very low?

Mr. AIDINOFF. I think you are talking about what a lawyer does when he advises a client individually about a tax shelter investment.

A lawyer obviously has the responsibility of giving his best opinion in terms of whether the tax shelter works or not.

Let us assume that the client at that point says, well, look, I have an offering circular here; you don't think that this works, and there is an opinion in the offering circular which, in effect, describes the argument that can be made for taking the deduction.

I suppose at that point, one gives his views as to whether those are 51-percent arguments, 45-percent arguments, or they are negligible arguments.

It seems to me if they are negligible arguments, and the client says, well, what are my chances of getting caught on it, the responsible lawyer has a duty, in effect, to lecture his client and say that it is improper to take those deductions on his return, irrespective of the likelihood of audit, and if the client is not going to follow that advice, one has to consider whether one wants to represent that client.

You are talking about a more difficult area when there is a substantial argument for the deduction, and where the lawyer is not comfortable in giving an affirmative opinion, and he believes in fact, if the matter is audited, the chances for success are less than even, but he does admit that there are substantial arguments, and he might be wrong.

I would say in that case, if the client says, well, I want to have a complete risk analysis made of this, and I have got to take into ac-

count the likelihood of audit, I think one can certainly mention what the likelihood of audit is, but point out that statistics, themselves, do not give the individual protection against his being selected for audit.

Two, in today's world, with the interest penalties, with the interest provisions having been changed, the downside risk is now so great that I think a lawyer can very competently say to his client, you know, if you are going to play the audit lottery, you should be aware of what these risks are, even in cases where there may be substantial argument for the position, and, in that case, perhaps the right answer is disclosure, at least when one is talking about an economic tax shelter, where disclosure does give a protection against the underestimation penalty.

Mr. SHANNON. Thank you very much.

Chairman RANGEL. What would you say, counselor, as chairman of the Section of Taxation of the American Bar Association; is your mandate regarding the tax law?

What is your job as chairman?

Mr. AIDINOFF. My job as chairman of the Tax Section is to administer a group which now has 25,000 lawyers and has committees which include 3,000 members and which cover just about every substantive and procedural question in the tax area.

Chairman RANGEL. What is your objective?

Mr. AIDINOFF. Our objective is to comment on just about everything new that is proposed in the tax law.

We certainly work for improvement in the tax law.

Chairman RANGEL. That was my question, whether or not you would work, whether you saw your mission to keep lawyers ethical and out of jail, or whether you felt some overall obligation to lawmaking, to improve the quality of the law, itself? I didn't know.

Mr. AIDINOFF. Our job is not to protect lawyers.

We are not responsible for promulgating ethical opinions. We are very concerned however about maintaining standards in tax practice.

Chairman RANGEL. When our Attorney General appeared to be involved in an investment that could be described as an abusive tax shelter, did the American Bar Association have any comments to make about the transaction or the law?

Mr. AIDINOFF. No, and one would not normally expect it to do so, but we have made many comments on abusive tax shelters, and let me say that, whether one uses the word abusive in the sense that it was used in your notice, or when one uses the word borderline tax shelter, I have got to say that any literate taxpayer ought to know that, if we are dealing with an investment outside of the real estate area, and there is no personal liability involved, one should look with caution at anything that provides more than a 1-to-1 tax benefit.

I am not familiar with the Attorney General's investment, other than the newspaper reports. I start out with a skepticism when I see a 4-to-1 investment in any area outside of real estate, except if the person has gone out and borrowed the money, or the partnership has done so, and there is personal liability.

Chairman RANGEL. I know the association's role when we have tax laws before us, either a committee or in conference, but this

role about advising as to how we can improve the quality of the system for the country, as opposed to clients, I had been ignorant of.

Mr. AIDINOFF. The partnership audit proposals that were adopted in TEFRA were largely the work of close cooperation between the IRS and the section of taxation of the American Bar Association.

The work really started in Commissioner Kurtz' administration, and that was done because we were concerned about our tax administration system not breaking down.

Chairman RANGEL. I am only trying to see whether I can get more exposure for the bar association's work in this area, not just their work with the Commissioner, or with the Service. I want the general public to know about the concern you have for improving the quality of law and avoiding loss of confidence in the tax system.

Mr. AIDINOFF. We have that same concern, Chairman Rangel, and I assure you that I will do my best to make sure we fulfill that obligation.

Chairman RANGEL. If it works here, then the AMA is next, and then we will believe anything.

Thank you for your statement and the materials you will be sending. The oversight committee will be reaching out for the opinions of the committee which you chair, and we hope that this relationship will make your job easier. It would certainly relieve our staff of a lot of problems, if you could reach out to your membership and find out how the law is actually working; so we just don't have to use hypotheticals.

Mr. AIDINOFF. I promise to give you my support.

[The following letter was subsequently received:]

SULLIVAN & CROMWELL,
New York, N.Y., October 15, 1982.

Hon. CHARLES B. RANGEL,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR CONGRESSMAN RANGEL: At the annual meeting of the American Bar Association that was held in San Francisco, the Section of Taxation presented a program on evolving standards for tax shelter opinions. I enclose a copy of the program materials which were distributed in connection with such presentation.

I also enclose a copy of the report of the Committee on Standards of Tax Practice of the Section of Taxation on "Guidelines to Tax Practice".

I trust that this information will be useful to you.

Very truly yours,

M. BERNARD AIDINOFF.

Enclosures.

[Additional enclosures can be found in the subcommittee files.]

Chairman RANGEL. Thank you very much.

Our last witness is Stephen Hester, an attorney from Washington, D.C.

Counsel, thank you for your concern about what is happening to our tax system generally and for sharing your comments both as a professor and as a practicing lawyer in Washington.

The staff asked me specifically to make certain that I thank you on their behalf for the cooperation which you have given in pulling together this hearing.

STATEMENT OF STEPHEN L. HESTER, ATTORNEY, WASHINGTON, D.C.

Mr. HESTER. Thank you, Mr. Chairman.

I will try to summarize my statement, and would like it to appear in the record.

Chairman RANGEL. It will appear in the record.

Mr. HESTER. Abusive tax shelters are a serious continuing problem despite the combined efforts of Congress and the tax enforcement authorities. The persistence of this problem is not only depriving the Government of revenue, but is undermining the pattern of voluntary compliance which forms the basis of our tax system.

We have heard a great deal of testimony about different types of tax shelters, but with the exception of real estate, one factor is common to all of these, and one abuse exceeds all others in this tax shelter area, and that is the availability of devices whereby for $10 spent, a taxpayer can buy 20 or 30 or 40 dollars' worth of tax deductions.

In other words, he can buy an investment for $10,000, deduct that entire investment plus an additional $10,000, $20,000, or $30,000.

A multiple writeoff of this kind is nonsensical and unfair. The average taxpayer understands that when he gives $10 to a charity, or pays $10 of interest expense, he is entitled to a deduction of $10. The widely advertised availability of so-called investments where $10 spent gives rise to a tax deduction of $30 or $40 breeds cynicism and bitterness. If a taxpayer in the 50-percent bracket claims a deduction of $40 on the basis of a $10 investment, the effect is exactly the same as if the Government paid the taxpayer $20 to buy a $10 investment which he owns. This inducement is entirely disproportionate to any sensible tax policy objective.

Because this abuse is so clear, in 1976 Congress enacted the at-risk rules of section 465 to prohibit abuses of this kind. Under this legislation, as explained in the Senate Finance Committee report, the tax shelter investor can only deduct his actual investment at risk including any amounts borrowed.

Since this statute has now been a part of the law for 6 years, the persistence of multiple writeoffs is due primarily to a failure of enforcement, not the flaws in the tax law itself.

Under section 465 if the taxpayer pays $10,000 to buy an interest in a tax shelter, the most he can deduct is $10,000. It does not matter whether the $10,000 comes from the taxpayer's earnings or from his savings, or it can come from borrowed amounts, if the taxpayer is personally liable to repay the debt.

A taxpayer cannot increase his at-risk amount by any transaction which is inconsistent with normal commercial practice, or is a device to avoid section 465.

A shocking abuse of this statute was recently recorded in the press. Each limited partner in an oil and gas tax shelter paid $16,500 in cash for an investment but claimed a 1981 tax deduction of $66,000, a so-called 4-to-1 writeoff.

This tax shelter was designed to circumvent the at-risk rules, because each investor agreed to pay an additional $49,500, without any interest, in 1993.

Tax shelter promoters, therefore, assert that section 465 is easily circumvented simply by putting off the risk for 10 or 20 or even 50 years.

Through this device investors are still being offered the chance to buy $4,000 of immediate tax deductions for $1,000 down, so long as they promise to pay the remaining $3,000 at some time or another, perhaps in 1993. A tax deduction purchased in this way is plainly contrary to proposed Treasury regulations which require at-risk transactions to conform to, and I quote, "normal commercial practices." Anyone who has recently tried to borrow money to buy a house or car will know that a 12-year, zero-interest loan does not reflect the normal commercial practices of the day. Mr. Chairman, I do not believe that any of us would buy 100 dollars' worth of clothing or groceries and offer to pay the bill—without interest—in 1993.

An argument of this type is childish. It would never be offered to a businessman, and is offered to tax authorities only because of the lack of respect with which those authorities are viewed by tax shelter investors. A tax shelter investor who claims a 4-to-1 writeoff and skips over the at-risk rules by promising to be at risk in 12 years is treating the IRS and the Congress with contempt.

A merchant or landlord would react with appropriate anger and energy to an offer to pay his bill in 12 years without interest. But tax shelter investors believe that the IRS, through blunder or procrastination, will not impose civil or criminal fraud penalties.

Investors in the tax shelter I have described unfortunately include the Attorney General of the United States. The Attorney General supervises the Government's tax litigation program, including litigation involving tax shelters, and he is reported to be one of the limited partners who bought $66,000 of 1981 tax deductions for $16,500 down, and $49,500 without interest in 1993.

This is an example of the serious enforcement problem that currently exists. I am not aware that the Treasury Department's Director of Practice, who has threatened to disbar lawyers who give unsupportable tax shelter opinions, has undertaken any investigation of the tax opinion issued in connection with the Attorney General's tax shelter.

I do not believe the SEC has instigated any investigation to determine whether the promoters of this tax shelter may have violated the securities laws by encouraging investors to claim tax deductions that are not legally available.

It is likely that the IRS will audit the Attorney General's tax shelter and disallow all or a major portion of the deductions claimed, but it is unlikely that the investors will be subject to any substantial penalties.

I do not suggest that this lack of enforcement is attributable to any specially favorable treatment of the Attorney General. It appears to be symptomatic of a widespread enforcement problem.

The at-risk rules enacted by Congress in 1976 are being flouted on a large scale and with apparent impunity. Tax deficiencies may ultimately be assessed and collected from the flouters. But as of

today, the flouters are living high and bragging to their neighbors about how little taxes they pay.

The tax shelter investment of the Attorney General will undermine the Government's tax shelter program, in my opinion. I believe that this program has not been as effective as it should be. But thousands of IRS and Justice Department employees are working to correct and prevent tax shelter abuses. These professionals are generally involved with tax shelters which offer far less than a 4-to-1 writeoff. A certain demoralization may be expected among the troops when they learn that their commander is fraternizing with the enemy.

Attorney General Smith has stated that he will give up part of the tax shelter deductions claimed on his 1981 Federal income tax return. The Attorney General has also announced that he will not participate in decisions involving the tax treatment of investments in energy drilling programs.

In my view, these actions are not adequate. The Attorney General's responsibilities continue for multiple writeoff tax shelters except for drilling programs. His department shares the responsibility for enforcing the at-risk rules of section 465. His subordinates are likely to participate in the future in cases which challenge the very tax device utilized by the Attorney General's tax shelter partners. Indeed, I would expect the Attorney General's endorsement of this device to lead to its proliferation. There are already indications of an increase in the availability of tax shelters which advertise a 4-to-1 writeoff.

At best, the tax shelter investment of the Attorney General produces a vacuum in our tax enforcement leadership. Abusive tax shelters will always be a temptation. To overcome it, our tax enforcement efforts need strong and energetic leadership.

The Attorney General announced he will not participate in this area of law enforcement. I submit that the Justice Department's efforts against tax shelters are not likely to achieve any outstanding results as long as the conflicting interests of the Attorney General prevent him from contributing to those efforts.

The abuse of the at-risk rules described above is illustrative of the problems involved in the great majority of abusive tax shelters. Abusive tax shelters are generally based upon a rationale or distinction which is so thin and unpersuasive that one would be ashamed to offer it in any other context.

For example, as referred to by the Commissioner of the IRS this morning, investors will buy lithographs or gems or books or records for $1,000, then revalue them for $4,000, donate them to a charity, and deduct them for tax purposes.

It is common knowledge what is bought for $10 is rarely worth $40. A tax shelter based upon a contrary premise is generally a sham. Yet similar examples continue to pass across the desks of many tax lawyers.

In my view the solution to abusive tax shelters does not lie in the enactment of more and more detailed laws by the Congress, or the issuance of more and more detailed IRS rulings. New laws and rulings are generally targeted against last year's tax shelters, but fail to deal specifically with the new variations which are introduced in the next year.

This problem can only be solved by an energetic program to enforce the civil and criminal penalties of existing law against the sellers and the buyers of abusive tax shelters.

I would be glad to respond to any questions, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF STEPHEN L. HESTER

Mr. Chairman, and members of the Committee, my name is Stephen Hester. I practice law in Washington, D.C. with the firm of Arnold & Porter, and specialize in the area of federal income taxation. I have also been an assistant professor of law at Duke University Law School and, more recently, an adjunct professor at Georgetown University Law Center. I welcome the Committee's invitation to appear here today and state some of my views concerning the problem of abusive tax shelters.

Abusive tax shelters are a continuing problem despite the combined efforts of Congress and the tax enforcement authorities. The persistence of this problem is not only depriving the Government of revenue, but is undermining the pattern of voluntary compliance which forms the basis of our tax system. Although the average taxpayer may not understand the mechanics by which tax shelters work, he is increasingly aware that abusive devices are used by large numbers of taxpayers to avoid paying their share of the tax burden. The honest taxpayer, who does not scheme to avoid his tax responsibilities, is beginning to feel like a chump. Too many of his fellow citizens are successfully dodging the tax collector.

The abusive tax shelter lies at the heart of this problem because such tax shelters are aggressively marketed and widely known. In 1980, the Treasury Department published proposed regulations dealing with abusive tax shelters which stated as follows:

"Apart from the loss of revenue, the widespread nature of such schemes undermines the public's confidence in the fairness of the tax system and may affect the level of voluntary compliance."

Now, two years later, it is most appropriate for this Committee to reassess the status of enforcement efforts directed against abusive tax shelter schemes.

To my mind, one abuse exceeds all others in the field of tax shelters: the continued availability of devices whereby a taxpayer can buy $20 or $30 or $40 of tax deductions for $10 spent. In other words, an investor who buys a tax shelter for $10,000 may deduct his entire investment plus an additional $10,000, $20,000 or $30,000. A multiple write-off of this kind is immediately perceived by the average citizen as nonsensical and unfair. The average taxpayer knows that when he gives $10 to his church or pays $10 of union dues or interest expense, he is entitled to a deduction of $10. The widely advertised availability of so-called "investments" whereby $10 spent gives rise to a tax deduction of $30 or $40 breeds cynicism and bitterness.

If a taxpayer in the 50 percent bracket claims a deduction of $40 on the basis of a $10 investment, the effect is the same as if the IRS paid the taxpayer $20 in order to induce him to make a $10 investment. This inducement is entirely disproportionate to any sensible tax policy objective.

Because of the clear nature of the abuse represented by multiple write-offs, in 1976 Congress enacted the so-called "at risk" rules of section 465 to prohibit multiple write-offs. Under this legislation, as explained in the Committee reports, a tax shelter investor cannot legally deduct more than his "actual investment . . . at risk," including any "amounts borrowed." In light of the fact that this statute has been part of the tax code for six years, the persistence of multiple write-offs is due primarily to a failure of enforcement, not to flaws in the tax law itself.

The at risk rules of Code section 465 are embodied in a well-conceived, tightly drafted statute. Except for real estate, all of the principal tax shelter investments are covered, includng oil and gas, motion pictures, farming, equipment leasing, etc. In each of these areas, the statute limits the maximum amount of deductions available to the amount actually at risk.

For example, if a taxpayer pays $10,000 to buy an interest in an oil and gas venture, the most he can deduct is $10,000. It does not matter whether the $10,000 paid comes from the taxpayer's earnings, from his savings, or from borrowed amounts, so long as he is personally liable to repay the debt. Under proposed Treasury Regulations, a taxpayer cannot increase his "at risk" amount by any transaction which is "inconsistent with normal commercial practices," or is a "device to avoid section 465." Prop. Treas. Reg. § 1.465-1(b). In short, a taxpayer cannot properly claim de-

ductions in an amount greater than the amount he risks—in a normal commercial sense—in buying an investment subject to section 465.

A shocking abuse of this statute was recently reported in the press. As described in the press, each limited partner in an oil and gas tax shelter paid $16,500 in cash for his investment but claimed a 1981 tax deduction of $66,000—a so-called 4 to 1 write-off. This tax shelter was designed to circumvent the at risk rules by having each investor agree to pay an additional $49,500—without interest—in 1993. The theory is that when Congress limited deductions to the amount at risk, it failed to specify at risk when. The tax shelter promoters therefore assert that this statute can be circumvented by putting off the risk for 10, 20 or 50 years.

Investors are still being offered the chance to buy $4,000 of immediate tax deductions for $1,000 down so long as they promise to pay the remaining $3,000 at some time or other—perhaps in 1993. A tax deduction purchased in this way is plainly contrary to proposed Treasury Regulations which require at risk transactions to conform to "normal commercial practices." Anyone who has recently tried to borrow money to buy a house or car, or to send a child to college, will know that a twelve year zero interest loan does not reflect the normal commercial practices of the day.

I suggest that none of us, including the investors in the tax shelter described above, would buy $100 worth of clothing or groceries and offer to pay the bill in 1993. An argument of this type—"you didn't say when to pay so I'll pay in 1993"—is childish. This argument would never be offered to a businessman, and is offered to the tax authorities only because of the lack of respect with which those authorities are viewed.

A tax shelter investor who claims a 4 to 1 write-off, and skips over the at risk rules by promising to be at risk in 1993, is treating the Internal Revenue Service and the Congress with contempt. A merchant or landlord would react with appropriate anger and energy to an offer to pay his bill in 12 years without interest, but the tax shelter investor believes that the IRS, through blunder or procrastination, will not seek to impose civil or criminal fraud penalties.

The investors in the tax shelter I have described above include the Attorney General of the United States. Although the Attorney General supervises the Government's tax litigation program, including litigation involving tax shelters, he is reported to be one of the limited partners who bought $66,000 of 1981 tax deductions for $16,500 down and $49,500, without interest, in 1993. This is an example of the serious enforcement problem that currently exists.

I am not aware that the Treasury Department's Director of Practice—who has threatened to disbar lawyers who give unsupportable tax shelter opinions—has undertaken any investigation of the tax opinion issued in connection with the Attorney General's tax shelter. I do not believe that the SEC has instigated any investigation to determine whether the promoters of this tax shelter may have violated the securities laws by encouraging investors to claim tax deductions that are not legally available. And although the IRS may audit the Attorney General's tax shelter and disallow all or a major part of the deductions claimed, it appears unlikely that the investors will be subject to any substantial penalties.

I am not suggesting that this lack of enforcement is attributable to any specially favorable treatment of the Attorney General. Indeed, it appears to be symptomatic of a widespread enforcement problem. The at risk rules enacted by Congress are being flouted on a large scale and with apparent impunity. It is possible that tax deficiencies will ultimately be assessed and collected from the floutes. But in the meanwhile, many flouters are living high and bragging to their neighbors about how little taxes they pay.

The investment by the Attorney General in a tax shelter designed to emasculate section 465 is bound to undermine the Government's tax shelter program. Although I believe that this program has not been as effective as it should be, thousands of government employees, including IRS agents and Justice Department lawyers, are working diligently to correct and prevent tax shelter abuses. These professionals are generally involved with tax shelters which offer far less than a 4 to 1 write-off. A certain demoralization may be expected among the troops when they learn that their commander is fratenizing with the enemy.

It should be noted that Attorney General Smith has stated that he will give up part of the tax shelter deductions claimed on his 1981 federal income tax return. The Attorney General has also announced that he will not participate in "any decisions involving the tax treatment of investments in energy drilling programs." In my view, these actions are inadequate.

Although the Attorney General has recused himself from issues involving energy drilling programs, his responsibilities continue for other types of tax shelters which

offer multiple write-offs. His Department shares the responsibility for enforcement of Code section 465, and his subordinates are likely to participate in cases which challenge the very tax device utilized by the Attorney General's tax shelter partners. Indeed, one can expect the Attorney General's endorsement of this tax device to lead to its proliferation. There are already some indications of an increase in the availability of tax shelters which advertise a 4 to 1 write-off.

At best, the tax shelter investment of the Attorney General produces a vacuum in our tax enforcement leadership. If we are to overcome the temptations presented to taxpayers by abusive tax shelters, our tax enforcement efforts need strong and energetic leadership. Instead of providing leadership, Attorney General Smith has announced that he will not participate in this area of law enforcement. The Justice Department's efforts against tax shelters are unlikely to achieve any outstanding results as long as the conflicting interests of the Attorney General restrain him from contributing to those efforts.

In my view, the abuse of the at risk rules characterized by the Attorney General's tax shelter investment is illustrative of the problems involved in the great majority of abusive tax shelters. Abusive tax shelters are generally based upon a rationale so thin and unpersuasive that one would be ashamed to offer it in any other context. For example, some years ago, it was common to sell investors lithographs or gems or books or records for $1,000 which would promptly be revalued at $3,000 or $4,000, donated to a charity, and deducted on one's tax return. It is common knowledge that what is bought for $10 is rarely worth $30. A tax shelter based upon a contrary premise is generally a sham. Yet similar examples continue to pass across the desks of tax lawyers.

I do not believe that the solution to abusive tax shelters lies in the enactment of more and more detailed laws by the congress, or the issuance of more and more detailed IRS rulings. New laws and rulings are generally designed to outlaw the last year's tax shelters, but they continue to be circumvented by new variations used to construct the next year's tax shelters. This problem cannot be solved except by an energetic program to enforce the civil and criminal penalties of existing tax law against the sellers and the buyers of abusive tax shelters. There appears to be little momentum in this direction at the present time.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Hester, for your testimony.

I think you raised a question that no one else discussed today, the at risk and when. How would you suggest that that could be corrected? By current law or new regulations or new law?

Mr. HESTER. I believe the statute is perfectly clear, Mr. Duncan, that when Congress said at risk, it meant that in the normal commercial sense. Indeed, the proposed regulations say that the statute should be interpreted to be consistent with normal commercial practice.

Now, any businessman knows that the risk represented by a promise to pay a dollar in 10 years is not a dollar. It is about 15 or 20 cents. To dignify an excuse of that kind by the enactment of a new statute or the issuance of a specific ruling, I think denigrates the plain meaning of the statute you passed 6 years ago.

Mr. DUNCAN. How would you do it?

You mentioned that the statute fails to state when and I repeat again, I think the question you raise is the most important one of the day.

Mr. HESTER. How would I enforce it, if I had the responsibilities of the Commissioner or something of that sort, do you mean?

Mr. DUNCAN. Yes, sir.

Mr. HESTER. I would use all of the provisions of existing law, the provisions involving injunctions against offerings of this kind, the imposition of civil and criminal penalties against the investors, and the bringing of criminal prosecution against the promoters.

I think the laws are there.

Mr. DUNCAN. How would you select the date, though?

You raised that question. How would you select the date for the at risk? You mentioned that in your statement.

Mr. HESTER. In the normal commercial sense, so that if you promise to pay $1,000 in 1993, and the promise is made in 1981, any investment banker or any kind of banker can tell you what that risk represents. It represents a risk of 15 to 20 cents on the dollar, so it is at risk. It is just clearly not a risk of a dollar, sir.

Mr. DUNCAN. Would you think that some of the tax shelters or more of them should be registered?

Mr. HESTER. I was very intrigued by your suggestion to that effect this morning.

I think that suggestion has a lot of promise. Obviously it could not apply to investments that are made singly or by small groups of people that are not promoted by broker dealers, but the notion that anything that is sold through broker dealers, and syndicated and advertised, should have to be registered is an excellent idea.

Mr. DUNCAN. I would be happy to receive any suggestions you might have along that line.

Mr. HESTER. I am not a securities lawyer, but a tax lawyer.

Mr. DUNCAN. You are a good tax lawyer, though.

Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Shannon.

Mr. SHANNON. I have no questions.

[The following material was subsequently received:]

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September 29, 1982

RECEIVED
SEP 30 1982
Ways and Means
Subcommittee on Oversight

Ms. Katherine Porter
Ms. Beth K. Kuntz
Committee on Ways and Means
Subcommittee on Oversight
1101 Longworth Building
Washington, D.C. 20515

Dear Katherine and Beth:

For your information, I am enclosing a "fact sheet" which was recently provided to me concerning a tax shelter which offers a 4-to-1 write-off. As you will see, this relies upon the same device as Yale-Quay except that the note is not due until the year 2000 and it provides for "nonrecourse" interest.

This type of shelter will be a problem to the IRS because it is not organized as a partnership and, therefore, may not be picked up by their current tax shelter audit programs. It is also designed to circumvent SEC rules -- what is sold is tangible property rather than a "security."

I appreciated your kind remarks at the end of the hearing the other day and hope I will have an opportunity to work with you again in the future.

Yours truly,

Stephen L. Hester

Enclosure

1982

Philatelic Leasing Ltd.

FACT SHEET FOR THE LEASING OF STAMP MASTERS

LOCAL POSTAGE STAMPS AND ANCILLARY PRODUCTS

SALES MATERIAL AND SERVICE
PHILATELIC LEASING LTD.
950 THIRD AVE., 28th FLOOR
NEW YORK, N.Y. 10022
(800) 223-5377 (212) 759-4824 (NYC)

TAX BENEFITS

4.2 TO 1 LEVERAGE IN 1982
4.0 TO 1 LEVERAGE IN 1983

PRODUCT

Philatelic Leasing Ltd. offers to lease Stamp Masters, each consisting of photographic color separations from which British local postage stamps for the islands of Bernera, Eynhallow and Staffa are produced, together with related copyrights. These stamps have been marketed to collectors since approximately 1847. These stamps can be used to prepay postage from the islands to the nearest British government post office on the mainland. They are also sold to topical stamp collectors in forms known as: perforated, imperforated, souvenir sheets and deluxe sheets. The Lessee will pay for the costs of printing the authorized quantities of these stamps, some of which are furnished to the islands free of charge for postal purposes, and most of which are retained by the Lessee for sale. Lease of the Philatelic stamp masters offers investors significant tax benefits and potential profits from sales of local stamps from the islands to the growing number of collectors who specialize in theme-oriented or topical stamps.

LESSEE'S OBJECTIVE

1. To exploit the Stamp Master in a commercial and businesslike manner so as to maximize revenues and profits on a long-term basis. 2. To participate in the continuing appreciation in the value of the stamps produced from the Stamp Master. 3. To retire partial recourse indebtedness possible through the sale of the stamps themselves. 4. To obtain the benefit of tax advantages available to Lessees of Stamp Masters.

LEASE RENTALS

Philatelic will lease stamp masters as follows:

	Annual Lease Payment
Two—Stamp Master	$30,000
Four—Stamp Master	$40,000
Six—Stamp Master	$50,000

Each lessee will receive two appraisals by recognized Philatelic (stamp) experts stating that the fair market value of the Stamp Master is at least equal to the purchase price paid by Philatelic. In addition, an appraisal shall be supplied to indicate the estimated revenues that may be derived from various ancillary products based on the stamp images produced for the Stamp Master.

FINANCING AVAILABLE

Philatelic will finance the annual lease payments as follows:

First Year: 50% of the cash portion at closing, 50% on February 1, 1983. The February payment is evidenced by a promissory note bearing interest at 10%. The balance of the first year's payment is made by a recourse note due February 1, 1990 bearing non-recourse interest at 10%.

Second Year: By delivery of a partial recourse promissory note due February 1, 1990 bearing 10% nonrecourse interest.

Third through Seventh Year: By delivery of a nonrecourse promissory note due February 1, 1990 bearing 10% nonrecourse interest.

All notes due in 1990 are secured by the products derived from the Stamp Master and 50% of all proceeds from sales of such products. Personal liability on the note is limited to a portion of the note and all payments on the note are first applied to reduce the portion for which the lessee is personally liable. Prepayment of the note is required to the extent of 50% of gross receipts after deduction of marketing or philatelic fees.

TAX ASSISTANCE

Should the Lessee adopt for tax purposes the approach outlined in the Information Memorandum and should such approach be challenged by the Internal Revenue Service or any local taxing agency, Philatelic Leasing Ltd. will provide, without cost to the Lessee, proper assistance in defending against any such challenge. In that connection, Philatelic Leasing Ltd. has retained the law firm of Friedman and Shaftan, P.C., 4 Park Avenue New York, New York and the accounting firm of Trager, Glass & Co., P.C., C.P.A.'s, 1790 Broadway, New York, New York, to be available upon request of the Lessee, to assist the Lessee's counsel and accountant if the Internal Revenue Service or any local tax agency challenges the tax structure of the transactions as set forth in the Information Memorandum dated June 1982 and the Lessee is unable to reach a satisfactory resolution at the initial audit level. Such assistance would involve appearance before the Appellate Division of the Internal Revenue Service and, if necessary, appearance before the United States Court, the United States District Court or the United States Court of Claims in connection with these matters.

TAX CONSIDERATIONS

Philatelic Leasing Ltd. has received an opinion of its counsel, Friedman and Shaftan, P.C., New York, concerning tax matters. Subject to the discussion contained therein, the opinion concludes that assuming that Philatelic elects to pass through the investment tax credit, a Lessee is entitled to a 10% investment credit on Philatelic's purchase price of a Stamp Master, which equals the total amount Philatelic has "at risk." A Lessee who properly elects the accrual method of accounting for his trade or business of exploiting the Stamp Master is also entitled to deduct a pro rata portion of the Lease Payments based on the number of months in the tax year in which the Lessee is in the trade or business of exploiting the Stamp Master and to currently accrue interest deductions on his notes, including the recourse and partial recourse notes. A cash basis taxpayer is entitled to a deduction for the pro rata share of the Lease Payments actually paid (the pro rata share being calculated in the same manner as for an accrual taxpayer) and interest when actually paid. Losses incurred in the venture are subject to an "at risk" limitation; such limitation is applied at the Lessee level. The "at risk" amount would include the cash payments made by a Lessee and all notes as to which the Lessee is personally liable including the recourse portion of the partial recourse note and amounts expended for operating expenses. Accordingly, Lessee of Stamp Masters will be allowed to deduct losses up to the total of those amounts. The availability of a substantial portion of these tax benefits depends on a factual determination that the Lessee is leasing the Stamp Master with the intent to engage in the business of exploiting the Stamp Master in order to make an economic profit (aside from tax benefits), and that the fair market value of the Stamp Master is at least equal to the purchase price paid therefor by Philatelic. The opinion is therefore issued in reliance on the existence of such facts. The above summary is qualified in its entirety by the detailed information appearing in the Information Memorandum.

National Marketing Office: 359 San Miguel Dr., Suite 110 Newport Beach, California 92660 (714) 644-2525
Regional Offices: Chicago, Houston, Seattle

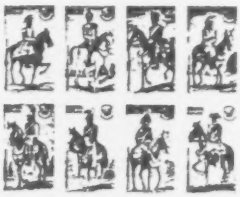
This Fact Sheet is offered only as a summary of the transaction and is not intended to be a definitive treatment of the business or tax aspects of the transaction. The Purchaser is urged to consult his own counsel. Each prospective Purchaser will receive an Information Memorandum setting forth various pertinent matters. This Fact Sheet is qualified in its entirety by the information appearing in the Information Memorandum.

Philatelic Leasing Ltd. June 1982. No part may be reproduced without permission.

DEFINITIONS

ISSUE—Each of the Master Plates leased from Philatelic carries with it the right to print the following limited editions of stamps; the entire edition is called an issue:

20,000 Sets Perforated Stamps
10,000 Sets Imperforated Stamps
10,000 Deluxe Sheets
20,000 Souvenir Sheets



Perf.-(Perforated)—A principal form of separation of stamps in universal use today where the paper between the stamps is cut away in a line of holes, usually round, leaving little bridges of paper between the stamps to hold them together.

Imperf.-(Imperforated)—Imperforated stamps are those issued without perforation between the individual stamps in the sheet. The earliest stamps were issued imperforated but after about 1860, most stamps were perforated. Modern imperforates are usually either errors or have been produced for sale to collectors as philatelic varieties.

Deluxe Sheet—Has the same general term as the Souvenir Sheet but usually has a different design generally larger than the Souvenir or Miniature Sheet and commands a considerable premium above the face value as they are normally presented as a Limited Edition.

Souvenir Sheets—(Souvenir Sheet and Miniature Sheet are interchangeable terms)—A small sheet of usually a single design, issued in conjunction with a commemorative occasion, depicting a person or subject. It often commands a premium above the face or nominal value.

British Local Postage Stamps—A type of stamp, the franking validity of which is limited to a town, district or route or between particular seaports. British local postage stamps are issued by the Islands of Eynhallow, Bernera and Staffa and are used to transport mail from each of the Islands to the nearest locale serviced by the British post office.

PRINTING OF STAMPS

Philatelic, as agent for the Lessee, will arrange for a maximum of two printings of stamps (if the Lessee so desires). The production fee is $2,000 for a two-stamp or four-stamp master and $2,500 for a six-stamp master. The maximum number of stamps that may be printed for each issue is 60,000 stamps.

The stamps will be produced under strict supervision. The Lessee will be required to deliver 500 each of the Perforated, Imperforated, Deluxe, and Souvenir sheets to the agents of the islands for local postage use and 20 of each to Philatelic. In addition, the postal agent may, in the future, require additional printings—at its own cost and expenses—for local postage usage.

Printing sets and sheets from the Stamp Master is as delicate as any fine art process. The printing process is overseen in every step of the production.

The graphic director approves the transfer of the original art to a lithographic plate in the initial step. This plate is dampened with water, then inked in one of the colors designated for a particular stamp. The ink clings to the greasy crayon marks with which the image is drawn, but not to the dampened areas. When a second, third or fourth color is utilized, the process is repeated for each color. Then a piece of paper is pressed against the plate, and the ink on the greasy parts is transferred to it.

ANCILLARY PRODUCTS

There are a number of companies that presently produce and market ancillary products created from stamps. These products include:

Postcards	Stationery
Business Logotypes	Interior Design Products
Calendars	Puzzles
Posters	Needlepoint Kits

Ancillary product managers contract with manufacturers and distributors to produce products based on stamp images from the stamp master. By direct contact and mail order, the ancillary agent negotiates with wholesalers and large retailers, independent sales representatives with complementary lines, and card and gift stores.

DISTRIBUTION

Once the four varieties of the particular stamp issue—Perforated, Imperforated, Souvenir, and Deluxe—are produced from the stamp master, the Lessee must distribute them. Some Lessees may elect to handle this task on their own. However, the vast majority of Lessees are likely to select an established distribution company. There are a number of such companies readily available and willing to handle the distribution of quality topical stamps. Philatelic cannot be a party to negotiations with these distributors. However, these distributors typically operate in several ways.

Generally, the distribution of postage stamps is conducted by three principal methods:

1. A stamp printer or producer supplies quantities of a particular stamp to a wholesaler. This wholesaler is typically a major dealer who acquires large quantities of stamps and markets them to smaller dealers, who in turn are retailers to even smaller, widely dispersed retail-oriented dealers. These dealers resell their allotment directly to the stamp-buying public.

2. A stamp printer or producer sells the entire quantity of a particular postage stamp issue to a large mail order distributor, who in turn solicits sales from consumers by means of various direct-mail stamp promotions. This method usually involves an exclusive agreement.

3. A stamp printer or producer may distribute the particular postage stamp issue produced by them directly to the consumer through retail divisions.

TYPICAL QUESTIONS

Q. WHAT IS A STAMP MASTER?

A. A Stamp Master consists of photographic color separations which may be used to produce local postage stamps and ancillary products which utilize the stamp image. A Stamp Master contains either two, four or six stamp images. The stamps have an aggregate face value of 1£ (Two-Stamp Master), 1.5£ (Four-Stamp Master) or 2.5£ (Six-Stamp Master) and may be printed in all cases, in a Limited Issue edition of 60,000 stamps.

Q. WHAT IS THE ECONOMIC POTENTIAL OF A STAMP MASTER?

A. The revenues that may be derived from sale of the stamps and the ancillary products have the potential not only to pay off the Lessee's entire obligation but to generate profits. Based on projections—without giving affect to inflation—sale of a portion of the stamps at wholesale may retire the partial recourse indebtedness. This does not take into consideration that stamps—including some British local postage stamps—historically have demonstrated an ability to appreciate in value.

Q. WHAT ABOUT THE NEW COLLECTIBLES MARKET?

A. For the first time in history, the average man is entering the collector's market. He cannot afford real estate, oil wells or blue period Picasso paintings, but now he is thinking like the very rich—he wants to invest. In this period of international inflation, the middle classes have very few avenues to invest their money as a hedge. British local postage stamps represent a potential to help fill this gap. Although British locals do not have the appeal of the international stamp issues to the purist stamp collector, they do have a certain niche within the topical stamp collecting community, a growing segment of the total of 22 million stamp collectors in the United States alone. The relationship between local and international issues might be likened to the relationship in the early 1960's of graphics to original oil paintings, whereas the graphic market, originally the step child of oil paintings, now outstrips oil paintings, and has become a major industry.

Q. WHAT ARE BRITISH LOCAL POSTAGE STAMPS?

A. One of the main reasons for the local stamp attraction is the relatively small size of these issues. Thus, the maximum number of stamps that may be printed from Philatelic Stamp Masters is 60,000 stamps per issue as compared to 300,000 stamps per issue for a small British Colony or more than 170,000,000 stamps per issue for large international issues from major countries such as France, Italy and the United States. It should be noted that usually a smaller issue of a limited edition of any product (art, sculpture, coins, etc.) is preferable to larger issues simply because over the years, the scarcity of available stamps increases their potential value. A number of private entities have for some time issued private local postage stamps which are now widely collected. Publications have been made of numerous catalogues and handbooks relating specifically to such stamps. It is anticipated that all of the stamp issues produced from the Stamp Masters offered for lease by Philatelic will be catalogued in the *Rosen Catalogue Of British Local Stamps*.

WHERE ARE THE ISLANDS?

Philatelic has obtained the rights to lease Stamp Masters for three islands located off the coast of Scotland. These islands—Bernera, Eynhallow and Staffa—retain a portion of each issue for use as local postage. The remainder are allocated for the collector's market.

Bernera is the largest of the three islands with a population involved in farming and "crofting". Its recorded history dates back to 1797 when evidence of the Norse invasion of the ninth century was uncovered in its language and nomenclature.

Eynhallow is a small island located between the island of Rousay and the Mainland off the North Coast at the entrance to Eynhallow Sound in Scotland. Eynhallow is the holy island of the Norsemen (Eynhallow means "holy island") and is well-known as the probable island of a Pre-Norse Christian settlement and a later monastery.

Staffa is an island located approximately seven miles west of Mull and seven miles northeast of Iona and is known for its cave formations and other striking features. It is famous for its unique basaltic formations and remarkable caves, the best known of which is Fingal's Cave, in which the music of the sea was immortalized by Mendelssohn in his celebrated "Hebrides" Overture. Its walls of clustered columns, its symmetrically pitched ceiling and its overall size and balance impart to it a cathedral-like majesty. The name Fingal is derived from the third century giant, Finn MacCumhaill, who defended the western isles from the seaborne attacks of raiders. Traces of homes and way of life of herdsmen and their families who once lived there still remain.

Q. WHAT TAX BENEFITS ARE AVAILABLE TO LESSEES OF STAMP MASTERS?

A. A Lessee of a Stamp Master to be used in a trade or business is entitled to a 10% investment tax credit (since an election to pass through the credit by Philatelic will be made), and a deduction for rental payments and interest expenses.

Q. WHAT MUST I DO WITH THE MASTER TO BE ENTITLED TO THE TAX BENEFITS DESCRIBED?

A. The availability of the tax benefits described is dependent on a determination that a Lessee is engaged in a trade or business of exploiting the Stamp Master for profit. The determination of whether an activity is engaged in for profit is subjective and depends on the nature and extent of the activities undertaken. Activities that would tend to show such motivation in this case include regular efforts to market products produced from the Master, maintenance of books and records, study and use of the accepted business practices of the stamp industry, the employment of professionals to assist in the conduct of the activity, and other similar activities which show the exploitation of the Master in a businesslike manner.

Q. HOW DOES THE LESSEE COMPLY WITH THE 1978 "AT RISK" LIMITATIONS?

A. In the opinion of our counsel (see Information Memorandum), a Lessee's initial amount at risk, for purposes of deducting losses, will include the cash payments made by him and all notes as to which the Lessee is personally liable, including the recourse portion of the long-term notes. Accordingly, the Lessee will be allowed to deduct losses up to the total of these amounts. The Lessee's initial risk amount is approximately sufficient, despite the at risk rule, to permit the maximum deductions for lease payments and interest during the first and a portion of the second year. However, the Lessee's at risk basis will not limit the amount of investment credit that will be available to the Lessee.

Q. HOW DOES THE LESSEE FIGURE THE INVESTMENT TAX CREDIT?

A. The amount used by the Lessee for determining the investment tax credit is, in the opinion of our counsel, the lesser of (a) the amount that Philatelic is "at risk" with respect to the Stamp Master leased to such Lessee or (b) fair market value of the Stamp Master. Philatelic will pay for each Stamp Master by a combination of cash and recourse notes; thus, its amount "at risk" should be the purchase price of each Stamp Master. Assuming the purchase price is not less than fair market value, each Lessee should be able to take an investment tax credit equal to 10% of Philatelic's purchase price paid by Philatelic for the Stamp Master.

Q. HOW CAN THE LESSEE FEEL CONFIDENT THAT THE FAIR MARKET VALUE IS NOT LESS THAN PHILATELIC'S PURCHASE PRICE OF THE STAMP MASTER?

A. Philatelic will be supplied with two appraisals from recognized experts in the stamp field with each purchase (copies of these appraisals will be provided to the Lessee). All appraisers used have made appraisals of stamps for many organizations and

individuals. The appraisers used will have evaluated the background of each stamp issue in arriving at the fair market value of the Master. In addition, Philatelic will receive an appraisal that will indicate the estimated revenues that may be derived from products produced from the Stamp Master, such as stationery, postcards, needlepoint, etc.

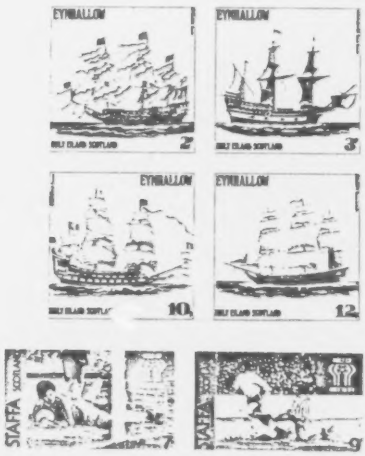
Q. WHAT ARE THE PREPAYMENT PROVISIONS OF THE LONG-TERM NOTES?

A. The Lessee has the right to prepay the long-term notes in whole or part at any time without penalty. The Lessee is also required to make prepayments to the extent of 50% of his net receipts from the sale of stamps and other products and from any other exploitation of the Stamp Master. Prepayment will first reduce the recourse portion and then the non-recourse portion of the long-term notes.

Q. WHAT HAPPENS IF THE PARTIAL RECOURSE NOTES HAVE NOT BEEN PAID WHEN THEY FALL DUE?

A. The portion of the long-term notes which have not been discharged through prepayments will fall due on February 1, 1990. In that event, the Lessee will be personally liable for the recourse portion of the notes less any prepayments he has made. In the event of nonpayment, Philatelic, as holder of the notes, will be entitled to various remedies of a secured party, including foreclosure of the property and proceeds. In the event of foreclosure the Lessee and Philatelic will each select an independent appraiser to appraise the value of collateral, and the average of these two appraisals will be credited against the amount due on the partial recourse note. If the two appraisals differ by more than 20%, the two appraisers will select a third appraiser whose appraisal will be binding.

Typical Stamp Master Products



Bernera Islands Scotland 60p

TWO STAMP MASTER

ILLUSTRATION OF TAX CONSEQUENCES

Annual Lease Payments: $30,000
Cash Portion of Lease Payment: $15,000
Recourse Portion of Lease Payments: $21,000
Cash Payment for Production: $2,000

Total Purchase Price of Stamp Master by Philatelic: $150,000
Assumed Tax Bracket: 50%

Assumed Closing Date: October 1, 1982

THESE FIGURES SHOULD NOT BE CONSIDERED PROJECTIONS. THEY ARE FOR ILLUSTRATIVE PURPOSES ONLY.

	Cash Outlay			Deductions				Tax			Equivalent Write-Off (6)	
Year	Cash Portion of Lease Payments	Production Costs (1)	Total	Lease Payments (2)	Interest (3)	Total Available Deductions	Amount Deductible Under 'At Risk' Rules	Tax Savings on Deductions	Investment Tax Credit (5)	Total	Dollars	Multiple
1982	$ 7,500	$2,000	$ 9,500	$ 7,500	$ 562	$ 8,062	$ 8,062	$ 4,031	$15,000	$19,031	$38,062	4.0
1983	7,500		7,500	30,000	2,250	32,250	29,938	14,969		14,969	29,938	4.0
Total	$15,000	$2,000	$17,000	$37,500	$2,812	$40,312	$38,000	$19,000	$15,000	$34,000	$68,000	4.0

Philatelic Leasing, Ltd.
Illustration of Tax Consequences

INTRODUCTION

This illustration relates to the lease of a stamp master, which will be used to produce stamps and other ancillary products for sale to the general public. This illustration should be examined in conjunction with the detailed tax opinion.

GENERAL ASSUMPTIONS

A. Although it is anticipated that there will be significant revenue from the sales of stamps and other products generated from the stamp master, they are omitted in the illustration pur-

poses. Similarly omitted are costs and expenses of exploitation other than the initial production costs, lease payments and interest.

B. Philatelic's entire purchase price is allocated to the stamp master.

C. This illustration is based on a stamp master valuation equal to Philatelic's purchase price as supported by appraisals. The lease payments, based on this purchase price, are in accordance with commercial business practice.

D. The taxpayer has the intent of exploiting the stamp master through a trade or business with a view to earning an economic profit.

NOTES

1. Production costs are not deductible when incurred but must be assigned to products produced and deducted upon their sale. The amount paid for such costs increases the purchaser's amount 'at risk' thereby allowing a greater deduction.

2. Lease payment deductions are based upon, in 1982, the number of months from the date of closing (October 1, 1982) to the end of the taxable year.

3. Interest deductions assume the election of the accrual basis of accounting by the taxpayer and an October 1, 1982 closing. Interest is computed at ten percent (10%) per annum on the principal amount of the long term notes.

4. Tax savings on deductions assume that the taxpayer has sufficient income taxed at fifty percent (50%) to be offset by the anticipated deductions.

5. The investment credit assumes that the stamp master is placed in service in 1982 and Philatelic properly elects to pass through the investment credit to the lessee.

6. In order to simplify the presentation of aggregate tax benefits, the investment credit has been converted into an equivalent write off on the basis of two dollars of deduction for one dollar of credit.

FOUR STAMP MASTER

PHILATELIC LEASING, LTD. ILLUSTRATION OF TAX CONSEQUENCES

Annual Lease Payments: $40,000
Cash Portion of Lease Payment: $20,000
Recourse Portion of Lease Payments: $29,000
Cash Payment for Production: $2,000

Total Purchase Price of Stamp Master by Philatelic: $200,000
Assumed Tax Bracket: 50%

Assumed Closing Date: October 1, 1982

THESE FIGURES SHOULD NOT BE CONSIDERED PROJECTIONS. THEY ARE FOR ILLUSTRATIVE PURPOSES ONLY.

	Cash Outlay			Deductions				Tax			Equivalent Write-Off (6)	
Year	Cash Portion of Lease Payments	Production Costs (1)	Total	Lease Payments (2)	Interest (3)	Total Available Deductions	Amount Deductible Under 'At Risk' Rules	Tax Savings on Deductions	Investment Tax Credit (5)	Total	Dollars	Multiple
1982	$10,000	$2,000	$12,000	$10,000	$ 750	$10,750	$10,750	$ 5,375	$20,000	$25,375	$50,750	4.2
1983	10,000		10,000	40,000	3,000	43,000	40,250	20,125		20,125	40,250	4.0
Total	$20,000	$2,000	$22,000	$50,000	$3,750	$53,750	$51,000	$25,500	$20,000	$45,500	$91,000	4.1

SIX STAMP MASTER

Annual Lease Payments: $50,000
Cash Portion of Lease Payment: $25,000
Recourse Portion of Lease Payments: $36,000
Cash Payment for Production: $2,500

Total Purchase Price of Stamp Master by Philatelic: $250,000
Assumed Tax Bracket: 50%

Assumed Closing Date: October 1, 1982

THESE FIGURES SHOULD NOT BE CONSIDERED PROJECTIONS. THEY ARE FOR ILLUSTRATIVE PURPOSES ONLY.

	Cash Outlay			Deductions				Tax			Equivalent Write-Off (6)	
Year	Cash Portion of Lease Payments	Production Costs (1)	Total	Lease Payments (2)	Interest (3)	Total Available Deductions	Amount Deductible Under 'At Risk' Rules	Tax Savings on Deductions	Investment Tax Credit (5)	Total	Dollars	Multiple
1982	$12,500	$2,500	$15,000	$12,500	$ 938	$13,438	$13,438	$ 6,719	$25,000	$31,719	$ 63,438	4.2
1983	12,500		12,500	50,000	3,750	53,750	50,062	25,031		25,031	50,062	4.0
Total	$25,000	$2,500	$27,500	$62,500	$4,688	$67,188	$63,500	$31,750	$25,000	$56,750	$113,500	4.1

Philatelic Leasing, Ltd.
Illustration of Tax Consequences

INTRODUCTION

This illustration relates to the lease of a stamp master, which will be used to produce stamps and other ancillary products for sale to the general public. This illustration should be examined in conjunction with the detailed tax opinion.

GENERAL ASSUMPTIONS:

A. Although it is anticipated that there will be significant revenue from the sales of stamps and other products generated from the stamp master, they are omitted for illustration purposes. Similarly omitted are costs and expenses of exploitation other than the initial production costs, lease payments and interest.

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C. This illustration is based on a stamp master valuation equal to Philatelic's purchase price as supported by appraisals. The lease payments, based on this purchase price, are in accordance with commercial business practice.

D. The taxpayer has the intent of exploiting the stamp master through a trade or business with a view to earning an economic profit.

NOTES

1. Production costs are not deductible when incurred but must be assigned to products produced and deducted upon their sale. The amount paid for such costs increases the purchaser's amount "at risk" thereby allowing a greater deduction.

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4. Tax savings on deductions assume that the taxpayer has sufficient income taxed at fifty percent (50%) to be offset by the anticipated deductions.

5. The investment credit assumes that the stamp master is placed in service in 1982 and Philatelic properly elects to pass through the investment tax credit to the lessee.

6. In order to simplify the presentation of aggregate tax benefits, the investment credit has been converted into an equivalent write-off on the basis of two dollars of deduction for one dollar of credit.

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October 1, 1982

Stephen L. Hester, Esq.
Arnold & Porter
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036

Dear Steve:

I read with interest your tax shelter testimony before the Subcommittee on Oversight of the House Ways and Means Committee. I was quite amused to receive in the mail yesterday an unsolicited invitation to participate in an oil and gas drilling program. The solicitation contained the enclosed message which rather dramatically underscores one of the points of your testimony.

Sincerely,

David Lake

F. David Lake, Jr.

Enclosure

If the Attorney General of the United States can receive a 4:1 tax write off on his oil and gas investments, so can you and your clients. The method is the minimum annual royalty program.

Chairman RANGEL. Let me thank you. We will continue to work with you, and I thank your firm, Arnold & Porter, for allowing you to come and share your views with us.

The subcommittee will stand adjourned.

[Whereupon, at 1:30 p.m., the hearing was adjourned.]

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